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No. _____

In The

Supreme Court of the United States

OCTOBER TERM, 1986

FRANKLIN AND JULIA MOORE,
individually and as representatives of a class,
Petitioners,

v.

EARLE R. FROST, JR. AND BROWNFIELD, BOWEN, BALLY & STURTZ, *Respondents.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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QUESTIONS PRESENTED

1. DOES THE HOLDING OF *LAVENDER V. KURN*, 327 U.S. 645 (1946) APPLY TO NON-FELA ACTIONS, THUS PRECLUDING A COURT OF APPEALS IN A NON-FELA ACTION FROM MAKING FINDINGS OF FACT ON APPEAL TO SET ASIDE A JURY VERDICT THAT HAS A REASONABLE EVIDENTIARY BASIS?

2. DOES AN ATTORNEY FOR AN ISSUER OF SECURITIES HAVE A DUTY TO CORRECT MATERIAL MISSTATEMENTS OF FACTS IN OFFERING CIRCULARS HE PREPARED FOR ON-GOING OFFERINGS, AFTER HE LEARNS THE STATEMENTS HE MADE ARE FALSE AND MISLEADING?

LIST OF PARTIES

The parties to the proceedings below were the Petitioners Franklin and Julia Moore, individually and as representatives of a class, and the Respondents Earl R. Frost, Jr. and the law firm of Brownfield, Bowen, Bally & Sturtz.*

*At trial, this class action also proceeded against Defendants Robert Hills, Charles McQueen, William West, and Bethel Securities. Rufus Hurst was a third-party Defendant. Only the judgments against Mr. Frost and Brownfield, Bowen Bally & Sturtz are involved in this petition.

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IN THE SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1986

FRANKLIN AND JULIA MOORE, individually and as representatives of a class, Petitioners,

v.

EARLE R. FROST, JR. AND BROWNFIELD, BOWEN, BALLY & STURTZ, Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

The Petitioners Franklin and Julia Moore respectfully pray that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Sixth Circuit, entered in the above-entitled proceeding on January 14, 1987.

OPINIONS BELOW

The opionion of the Court of Appeals for the Sixth Circuit is reported at 809 F.2d 297 and is reprinted in Appendix A.

JURISDICTION

The Opinion and Order (Mandate) of the United States Court of Appeals for the Sixth Circuit was entered on January 14, 1987.

The jurisdiction of this Court is invoked under 28 U.S.C. §1254 (1).

STATUTES INVOLVED

Relevant constitutional provisions, statutes and regulations are set out in Appendix B.

STATEMENT OF THE CASE

1. Proceedings Below

This is a class action by Franklin and Julia Moore ("Petitioners") on behalf of all purchasers of Fenex oil and gas joint

ventures and HMW well equipment limited partnerships, against the former officers, directors, attorneys and salesmen of the "Bethel Group" which includes Fenex, Inc. ("Fenex"), HMW Company, Inc. ("HMW"), and Bethel Securities Company ("Bethel Securities"), their brokerage firm, for violations of federal and state securities laws and for Ohio common law fraud and breach of fiduciary duties. Amended Complaint, R. 21.

Only the judgments against Respondents Earl R. Frost, Jr., Esq. and his law firm, Brownfield, Bowen, Bally & Sturtz, securities attorneys for the Bethel Group, are involved in this Petition.

Plaintiffs claim that Mr. Frost and his law firm aided and abetted their clients, Fenex and HMW, in making false and misleading statements of material facts to the class, thus violating §10 of the Securities Exchange Act of 1934, 15 U.S.C. §78j, Rule 10b-5, 17 C.F.R. §240.10b-5, and the Ohio Securities Act, Ohio Rev. Code §1707.41, *et seq.* In addition, Plaintiffs claim that the actions of Mr. Frost and his firm constitute common-law fraud and a breach of fiduciary duties.

In answer to Special Interrogatories, the jury found Mr. Frost liable for $40,000 for violations of federal securities laws, $40,000 for breach of fiduciary duties, and $40,000 for fraud. His law firm was found liable for $60,000 for violations of federal securities laws and $60,000 for breach of fiduciary duties. Special Interrogatories, R. 174. Judgment was entered in accordance with the verdict. Judgment Entry, R. 181.

2. Basis for Federal Jurisdiction

There is federal question jurisdiction, 28 U.S.C. §1331, for Petitioners' claims for violations of the Securities Exchange Act of 1934, 15 U.S.C. §78aa. There is pendent jurisdiction over Petitioners' claims for common-law fraud, breach of fiduciary duties and violations of the Ohio Securities Act, Ohio Rev. Code §1707.41. *et seq.*

3. Statement of Facts

a. Mr. Frost is Securities Attorney For the Bethel Group.

Mr. Frost and his law firm incorporated the Bethel Group and prepared all the registration statements and offering circulars for Fenex and HMW's public offerings. HMW sold intangible working interests in oil wells, and Fenex sold limited partnership

interests in the drilling equipment for Fenex wells. T.P., R. 193 at 525, 533. Between 1976 and 1981, a total of fifty-one separate public offerings were prepared and registered with the Ohio Division of Securities by Mr. Frost and his law firm, and sold by Fenex and HMW. Almost every business day for five years, a Fenex or HMW offering circular was being prepared by the attornerys or being sold by the Bethel Group's securities salesmen. T.P., R. 197 at 1077-1078; PX 109.

b. Robert R. Hills and Rufus B. Hurst Controlled the Bethel Group.

Defendant Robert R. Hills owned 45% of the stock of Fenex, 45% of the stock of Bethel Securities and 78% of the stock of Bethel Resources. Mr. Hills controlled Bethel Resources, Fenex, HMW and Bethel Securities. He was a member of the board and was president of HMW, Bethel Resources and Bethel Securities. He was also secretary-treasurer and a director of Fenex. Stipulation, R. 123 at 12; PX 101. Rufus B. Hurst was the Bethel Group's Manager. T.P., R. 193 at 518-521.

c. "Robbing Peter to Pay Paul"

Fenex joint ventures and HMW limited partnerships were "turn-key" offerings in which investors were only liable for the purchase price of their interests. T.P., R. 193 at 525, 533. Thus, if Fenex was unable to complete a well or HMW was unable to equip a well from funds provided by investors for that particular venture, then Fenex or HMW had to acquire funds to satisfy their obligations to investors from some other source. T.P., R. 193 at 525, 526, 533.

It was contemplated that Bethel Resources would drill and equip Fenex's wells, and that, for that purpose, HMW might turn over investors' funds to Bethel Resources. Thus, the ability of Fenex and HMW to meet their obligations to investors depended on the financial strength of Bethel Resources. *See* T.P., R. 193 at 532, 533.

Faced with losses in every aspect of its business, the Bethel Group began "robbing Peter to pay Paul." According to the Bethel Group's accountant, this meant:

That Peter would have some money. Paul had a lot of bills and so Peter would loan Paul the money to pay those bills. T.P., R. 193 at 434.

The instrument to rob Peter to pay Paul was "the sheet", a listing of funds in Fenex and HMW investors' accounts prepared by the accounting department for Mr. Hurst on a daily basis. T.P., R. 193 at 555; T.P., R. 192 at 389-390. At Mr. Hurst's direction, funds were then taken out of the investors' accounts in Fenex and HMW and spent for unrelated purposes. T.P., R. 192 at 390, 392; T.P., R. 193 at 433. None of this was disclosed to potential investors. Offering Circulars, PX 100, PX 101.

d. Mr. Frost's Knowledge of Conversion of Investors' Funds and Participation in the Fraudulent Sales of Securities.

1. Mr. Frost Learns Fenex Has Commingled Investors' Funds.

On June 23, 1980, the Ohio Division of Securities began a routine audit of Bethel Securities. T.P., R. 198 at 1288-1291. On August 28, 1980, when Mr. Hurst, Manager of Fenex and HMW, was unable to produce invoices for the Division showing the proceeds from the offerings had, in fact, been used to drill the wells, Mr. Frost met with him at Mr. Hurst's office. T.P., R. 197 at 1135-1137.

Mr. Frost asked to see the separate passbook accounts for the well packages. Mr. Frost testified:

> So I asked him where they were and basically, he explained that they didn't have separate passbook accounts for Fenex or Bethel and that they had taken all the money and put it in this cash management account . . . T.P., R. 197 at 1137.

This commingling of funds was a violation of the representation in Fenex offering circulars that funds would be kept in separate passbook accounts until expended for drilling purposes. PX 100. Mr. Frost testified that he regarded the discovery of commingling of funds on August 28, 1980 as a very serious event. T.P., R. 197 at 1142. The record shows that two HMW limited partnerships and one Fenex joint venture, with a total sales value of $502,500, were being sold to the public on August 28, 1980; yet Mr. Frost did nothing to cause his client to disclose to purchasers of ongoing offerings that the Bethel Group funds had been commingled. T.P., R. 197 at 1142; PX 109.

2. Mr. Frost Learns Fenex Has Converted Investors' Funds.

A few days after August 28, 1980, Mr. Frost met with Mr. Robert Hills and Mr. Hurst to review the cash management account. Mr. Frost testified:

> It didn't show much because they had to wait for their monthly statement and the only ones that showed transactions going in and out and you couldn't tell from one package or another where the funds came from or where they went, quite frankly. And so then I asked Hurst to make a complete evaluation of the wells and which ones were drilled and completed, which ones partially drilled and hadn't been fracked or hadn't been hooked up and get me some numbers as to what the situation was. At that point in time, which I believe was in the beginning of October, I knew that they were short money.
>
> Q. What do you mean short money?
>
> A. I mean that they didn't have enough money to complete the wells that they were suppose to do.
>
> Q. Am I correct, you also knew that they could not account for the disposition of funds from the cash management account?
>
> A. Well, they had money in the cash management. They couldn't account to where it went.
>
> Q. Did you regard that as being serious?
>
> A. I was upset. That's why we went to all this work. T.P., R. 197 at 1151-1153.

Mr. Frost then asked Mr. Hurst to make a complete evaluation of the wells, showing which wells were drilled and completed and which were partially drilled. T.P., R. 197 at 1151, 1152. In response to questions by the Court, Mr. Frost testified that he was aware that trust funds had been commingled, and that Fenex was short money. T.P., R. 197 at 1158, 1159.

On November 26, 1980, after Mr. Frost was aware that there were substantial shortages in Fenex investors' accounts, he registered an additional offering for Fenex, without disclosing the conversion or the shortages. PX 109; 150, 151; T.P., R. 197 at 1155, 1156.

3. Mr. Frost Learns Fenex and Bethel Resources Have Converted $709,000 In Investors' Funds and Need $830,000 To Complete Their Wells.

On January 22, 1981, Mr. Hurst gave Mr. Frost a written statement which showed that Fenex and Bethel Resources had converted $709,000 from investors' accounts, and needed an additional $830,000 just to complete and equip investors' wells. DX 426; T.P., R. 194 at 707; R. 195 at 745-746. On that date, the $243,750 Fenex offering Mr. Frost registered in November was still being sold to investors. In addition, three HMW offerings, with a combined price of $275,000, were being sold to investors. PX 109.

4. Mr. Frost Did Not Give The Ohio Division of Securities The Written Statement Showing The Conversion of $709,000 And The Need For $830,000 To Complete Investors' Wells Until The Division Subpoenaed The Records In 1982.

Although Mr. Frost claimed he gave Mr. Hurst's computations to the Ohio Division of Securities, his star witness, Ohio Securities Commissioner Roger Marting, testified that Mr. Hurst's computations were not received by the Division until subpoenaed in an administrative proceeding in 1982, after the collapse of the Bethel Group. *Compare* Frost testimony, T.P., R. 197 at 1151, 1186; *with* Marting testimony, T.P., R. 198 at 1325-27.

5. Mr. Frost Registers More Fenex Securities.

Mr. Frost prepared and registered an offering circular for a $247,000 Fenex joint venture on February 3, 1981. The only addition to the usual boilerplate in the February 3, 1981 offering circular was as follows:

> Said entities are experiencing a serious cash flow (sic) and are seeking a $500,000 loan . . . T.P., R. 197 at 1171-4.

6. The Jury Verdict.

In answer to the Special Interrogatories, the jury found Mr. Frost and his law firm liable for a total of $240,000, almost the exact amount of the February 3, 1981 offering circular. Verdict, R. 175.

7. Opinion Of The United States Court Of Appeals For The Sixth Circuit.

From conflicting direct and circumstantial evidence, the Sixth Circuit made its own factual findings to reverse the jury verdict. *See,* Opinion at 8-10. On the basis of its factual determinations, the Sixth Circuit found that "the trial court erred in failing to grant a directed verdict in favor of Frost and the Brownfield firm on the issue of fraud." Opinion at 11. In addition, the Sixth Circuit found, as a matter of law, that Frost was under no duty to correct the offering circular most recently issued when he learned that Fenex had failed to segregate investors' funds. Opinion at 17.

REASONS FOR GRANTING THE WRIT

I.

The Sixth Circuit's Test For Determining Whether There Is Sufficient Evidence to Create A Jury Issue Is In Conflict With Decisions Of This Court and Other Circuits.

A. The Sixth Circuit Made Findings of FAct Contrary to the Evidence Presented at Trial.

In this case, the Sixth Circuit made findings of fact on appeal to set aside a jury verdict which had a reasonable evidentiary basis. The Sixth Circuit searched the record for conflicting circumstantial evidence and made its own findings of fact:

a. The Sixth Circuit made the factual determination that Plaintiffs' only claims for fraud were as follows:

> Plaintiffs' first claim of fraud was that Defendants misrepresented in the offering circulars that the funds invested would be segregated for use for the particular well offered . . . The other allegation of fraud dealt with Frost's non-disclosure of the companies' financial troubles. Opinion at 8-9.

In fact, however, Plaintiffs claimed that Defendants converted proceeds from Fenex and Bethel Resources offerings, and Mr. Frost and his firm knowingly or recklessly failed to disclose the conversion in subsequent Fenex and HMW offering circulars. Amended Complaint, R. 21;

b. The Sixth Circuit made the factual determination that when Mr. Frost learned of Fenex's cash flow problems in 1980, he reported that information to the Ohio Division of Securities. Opinion at 9. **At trial, however, Mr. Frost's star witness, Ohio Securities Commissioner Roger Marting, testified that the documents stating that $709,000 had been converted and Fenex required $830,000 to complete the wells was not received by the Division until subpoenaed in an administrative proceeding in 1982, after the collapse of the Bethel group. *Compare* Mr. Frost testimony, T.P., R. 197 at 1151, 1186; *with* Marting testimony, T.P., R. 198 at 1325-27;**

c. The Sixth Circuit made the factual determination that the undisputed evidence showed that by the time of the December 9, 1980 Fenex offering, all of the "relevant" parties involved felt that Fenex's problem had been solved. Opinion at 10.
The evidence at trial, however, showed that the purchasers of these offerings were never told of the commingling or the conversion of funds. T.P., R. 197 at 1171-74;

d. The Sixth Circuit made the factual determination that the February 3, 1981 Fenex offering circular adequately disclosed the conversion of investors' funds. Opinion at 9. **The evidence at trial, however, showed that all Mr. Frost disclosed in the February 3, 1981 offering circular was that "said entities are experiencing a serious cash flow [sic] and are seeking a $500,000 loan . . ." T.P., R. 197 at 1171-74;**

e. The Sixth Circuit made the factual determination that the conversion of over $500,000 was equivalent to "serious cash flow problems" that could be remedied by a bank loan. Opinion at 9. **The evidence at trial, however, showed that Mr. Hills and Mr. Hurst had converted $709,000 from offerings of Fenex and needed $830,000 to complete the wells. DX 426; T.P., R. 195 at 745-46;**

f. The Sixth Circuit made the factual finding that there were no material non-disclosures in HMW offering circulars. Opinion at 9. **The evidence at trial, however, showed that Mr. Hills, the general partner in all HMW offerings, had converted $709,000 from offerings of Fenex (the entity that was supposed to drill the wells for HMW equipment) and that Fenex needed $830,000 to complete the wells. These facts were never disclosed to HMW investors. *Compare* HMW offering circulars, PX 101, *with* DX 426; T.P., R. 195 at 745-46. The Sixth Circuit did not even consider that a reasonable investor in HMW would want to know that Mr. Hills, the general partner, had converted $709,000 from the entities that were supposed to drill the wells and needed $830,000 to finish the wells on which HMW equipment was to be placed.**

Based on these *de novo* factual determinations, the Sixth Circuit vacated the jury verdict and found that the trial court had erred in failing to grant a directed verdict in favor of Mr. Frost and his firm on the issue of fraud. Opinion at 11.

B. **Conflict with Decisions of this Court.**

In its opinion, the Sixth Circuit correctly stated that a reviewing court should reverse a jury verdict only when there is a complete absence of proof on the issues or no controverted issues of fact upon which reasonable minds could differ. Opinion at 10. The Sixth Circuit's error was not in stating the standard for review, but in applying it.

The Court incorrectly determined that the standard of review permitted an appellate court to make its own findings from disputed facts and reverse a jury verdict that had a reasonable evidentiary basis. In this manner, the Sixth Circuit misapplied its standard of appellate review and contradicted this Court's numerous FELA cases, which hold that an appellate court may not invade the constitutionally protected province of the jury.

In the leading case of *Lavender v. Kurn*, 327 U.S. 645 (1946), this Court explained an appellate court's function in reviewing the sufficiency of the evidence to create a jury issue:

> It is no answer to say that the jury's verdict involves speculation and conjecture. Whenever facts are in dispute or the evidence is such that fair-minded men may draw different inferences, a measure of speculation and conjecture is required on the part of those whose duty it is to settle the dispute by chosing what seems to them to be the most reasonable inference. *Only when there is a complete absence of probative facts to support the conclusion reached does a reversable error appear.* But where, as here, there is an evidentiary basis for the jury's verdict, the jury is free to discard or disbelieve whatever facts are inconsistent with its conclusion. And the appellate court's function is exhausted when that evidentiary basis becomes apparent, it being immaterial that the court might draw a contrary inference or feel that another conclusion is more reasonable.

Id. at 653 (emphasis added).

In other FELA cases, this Court has said that "it is not the function of a court to search the record for conflicting circumstantial evidence in order to take the case away from the jury on a theory that the proof gives equal support to inconsistent and uncertain inferences." *Tennant v. Peoria & Perkin Union R.R. Co.*, 321 U.S. 29, 35 (1944). Further, this court has held in a FELA case that the jury should be presented with a claim whenever the "proofs justify with reason" the inference desired even though "the jury may also, with reason, on grounds of probability" draw a different inference. *Rogers v. Missouri Pacific RR. Co.*, 352 U.S. 500, 506 (1957).

In these and similar decisions, this Court has emphasized that a reviewing court must respect the jury's historic function under the Seventh Amendment. For example, in Lavender, this Court found as follows:

> The jury having made that inference, the respondents were not free to relitigate the factual dispute in a reviewing court. Under these circumstances, it would be an undue invasion of the *jury's historic function* for an appellate court to weigh the conflicting evidence, judge the credibility of witnesses and arrive at a conclusion in opposition from the one reached by the jury.

Lavender, 327 U.S. at 652-53 (citation omitted) (emphasis added). See also, *Tiller v. Atlantic Coast Line R.R. Co.*, 318 U.S. 54, 67-68 (1943); *Atlantic & Gulf Stevedores, Inc. v. Ellerman Lines, Ltd.*, 369 U.S. 355, 360 (1952); *Rogers v. Missouri Pacific R.R. Co.*, 352 U.S. 500, 508 n. 18 (1957).

The Sixth Circuit, however, ignored this Court's holdings by reevaluating the evidence and making factual findings from disputed direct and circumstantial evidence on appeal in opposition to the jury's conclusion. If the Sixth Circuit's judgment is correct, a Court of Appeals may reevaluate the evidence in any fraud case, thus totally supplanting the function of the jury. Such a course of conduct is clearly contrary to the admonition in *Lavender* that the "apellate court's function is exhausted" unless "there is a complete absence of probative facts to support the [jury] conclusion reached." *Lavender* 327 U.S. at 653.

C. Conflict With The Decisions of Other Circuits, Its Own Prior Decisions, and Commentators.

The United States Courts of Appeals are bewildered and divided on the issue of whether this Court's FELA cases set a uniform federal standard for all civil trials. For example, in *Wratchford v. S.J. Groves & Sons Co.*, 405 F.2d 1061, 1066 n. 14 (4th Cir. 1969), the Fourth Circuit accepted *Lavender* as establishing the standard for use in all diversity cases. Likewise, the Eighth Circuit has applied the *Lavender* standard of review to non-FELA actions. *Continental Can Co., v. Horton*, 250 F.2d 637, 643 (8th Cir. 1957).

In total contradiction of the Fourth and Eighth Circuits, however, the Fifth and Seventh Circuits confine *Lavender* to FELA cases. In *Boeing Co. v. Shipman*, 411 F.2d 365, 372 (5th Cir. 1969), for example, the Fifth Circuit overruled its own earlier decisions in holding as follows:

> Though we have heretofore adopted . . . the FELA test of the sufficiency of evidence to create a jury question as a uniform federal standard fashioning a rule of general application, we now reject [the FELA test] . . . and hold that the FELA test is peculiar to that kind of case as a consequence of the statute itself and is accordingly not applicable to non-FELA jury trials.

Similarly, the Seventh Circuit has refused to apply this Court's FELA decisions in non-FELA actions:

> There can be no doubt that a majority of the Supreme Court, as presently constituted, regards FELA cases as something apart and different . . . , and that a different rule or test applies.

Gibson v. Elgin, J. & E.R. Co., 246 F.2d 834, 841 (7th Cir. 1957) (on Petition for Rehearing).

The confusion among the Circuits is mirrored in the Sixth Circuit's own inconsistency. In this case, the Sixth Circuit cited a standard of appellate review similar to *Lavender*, but didn't apply it. In prior decisions, two distinct lines of cases have been decided by different panels of the Sixth Circuit.

In one line of cases, panels of the Sixth Circuit have applied the *Lavender* standard of review to non-FELA actions. In *Lones v. Detroit, Toledo and Ironton R.R. Co.*, 398 F.2d 914, 919 (6th Cir. 1968), for example, a panel of the Sixth Circuit quoted *Lavender v. Kurn* as the "federal standard". Likewise, in a recent patent infringement case, a panel of the Sixth Circuit quoted *Lavender* for the long standing rule that "only when there is a complete absence of probative facts to support the [jury] conclusion reached does a reversible error appear". *U.S. Phillips Corp. v.*

Ferro Corp., 522 F.2d 1100, 1101-2 (6th Cir. 1975). In the case at bar, a panel of the Sixth Circuit quoted, but misapplied, a standard of review very similar to *Lavender*. Opinion at 10.

On the other hand, a second line of Sixth Circuit cases have refused to apply the *Lavender* standard in non-FELA actions. In *Jellison v. Kroger Co.*, 290 F.2d 183 (6th Cir. 1961), for example, a panel of the Sixth Circuit appeared to adopt the view that *Lavender* was "intended to apply only to cases arising under the Federal Employer's Liability Act, 45 U.S.C.A. §51 et seq., and should not be extended generally in negligence cases." *Id.* at 185-86 (citing to *Preston v. Safeway Stores, Inc.*, 269 F.2d 781 (D.C. Cir. 1959). In support of that proposition, a panel of the Sixth Circuit recently found that "the deference given the jury's interpretation of the facts is even greater in FELA cases." *Clark v. Kentucky and Indiana Terminal R.R. Co.*, 728 F.2d 307, 310 (6th Cir. 1984).

Until this Court settles the issue, there will be conflict and inconsistency among different circuits and even among different panels in the same circuit.

The commentators are of no assistance to the lower courts. Several commentators, relying on the jury's constitutionally protected right to make factual findings, argue that this Court's FELA decisions should be applicable in non-FELA actions. *See*, DeParq, *The Supreme Court and the Federal Employers' Liability Act, 1960-61 Term*, 39 Chi.-Kent L. Rev. 127 (1962S); Green, *Jury Trial and Mr. Justice Black*, 65 Yale L.J. 482 (1956). Other commentators, relying on the uniqueness of the FELA statute, argue that *Lavender* should be confined to FELA actions. *See*, Blume, *Origin and Development of the Directed Verdict*, 48 Mich. L. Rev. 555 (1950); Gee, *A Dissenting Postcript*, 36 Texas L. Rev. 157 (1957); Comment, *Directed Verdicts in Civil Actions*, 47 Mich. L. Rev. 974 (1949); Note, *Rule 50(b): Judgment Notwithstanding the Verdict*, 58 Colum. L. Rev. 517 (1958). *See also*, 5 J. Moore, *Federal Practice* §50.02 (2d ed. 1968).

In sum, the federal standard for appellate review of a denial of a directed verdict motion is in a state of conflict and confusion. For many decades, this Court has liberally granted certiorari in FELA actions in order to assure that an appellate court does not invade the protected province of the jury. *See*, *Rogers v.*

Misssouri Pacific R.R. Co., 352 U.S. 500, 534 (1957) (Frankfurter, J., concurring) (listing the 124 times that certiorari had been granted to review the lower courts' sufficiency of evidence test as applied in FELA actions).

In addition to protecting the constitutional role of the jury, this Court can end the conflict and confusion among the lower courts by granting this petition for writ of certiorari. As Wright and Miller have emphasized, "a decision by the Supreme Court, clearly stating which view it takes as to the scope of the FELA and Jones Act decisions, would be of helpful guidance to the lower federal courts." 9 C Wright & A. Miller, *Federal Practice and Procedure* § 2526 (1971).

II.

The Lower Courts And The Securities Bar Need This Court's Guidance In An Important Question of First Impression Under The Federal Securities Laws: Does An Attorney For An Issuer Of Securities Have A Duty To Correct Material Misstatements of Facts In Offering Circulars He Prepared For Ongoing Offerings, After He Learns The Statements He Made Are False and Misleading.

This case raised, for the first time in a United States Court of Appeals, the important question whether an attorney has a duty to correct or disclose known misstatements and omissions of material fact in offering circulars he has prepared.

On August 28, 1980, the day Mr. Frost learned that Fenex and HMW did not keep segregated accounts and that funds were missing from investors' accounts, there was one Fenex and two HMW offerings on the street being sold to investors with a total offering price of $502,500. T.P., R. 197 at 1112; PX 109.

On January 22, 1981, the date that Mr. Frost received a list which showed that Fenex and Bethel Resources had converted $709,000 from investors' accounts and needed an additional $830,000 just to complete and equip investors' wells. DX 426; T.P., R. 194 at 707; R. 195 at 745-41. On that date, the $243,750 Fenex offering Mr. Frost registered in November was still being sold to investors. In addition, three HMW offerings, with a combined price of $275,000, were being sold to investors. PX 109.

The Trial Court held, as a matter of law, that Mr. Frost and his law firm could not be held liable for misrepresentations and omissions in these offering circulars being sold on August 28, 1980, even though Mr. Frost learned of the misstatements and omissions while they were actually being sold to investors. T.P. R. 197 at 1149. As a matter of law, the Trial Court held that Mr. Frost, as an attorney, did not have a duty to advise his clients to rectify the fraud. T.P., R. 197 at 1143.

The Sixth Circuit agreed, holding as a matter of law, that an attorney need not correct a materially misleading offering circular if the attorney insists "that his clients comply with the representations made in the offering circulars." Opinion at 18. Thus, the Sixth Circuit substituted a new duty "to insist on compliance" for the traditional disclosure requirements of the federal securities laws. Moreover, the Court refused to establish a "hard and fast rule" or give any criteria upon which other Courts could rely.

In *Touche Ross & Co. v. Redington* 442 U.S. 560, 575 (1979), this Court found that the "central inquiry" in interpreting the scope of private actions under the federal securities laws is to determine Congress' intent. *See also, Blue Chip Stamps v. Manor Drug stores*, 421 U.S. 723, 756 (1975). The Sixth Circuit, however, made a far-reaching decision without any examination of the Securities Exchange Act of 1934 or its legislative history. Indeed, the Sixth Circuit ignored the fact that the very purpose behind the federal securities laws is to "provide investors with full disclosure of material information" and to "protect investors against manipulation of stock prices." *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 195 (1976). The Sixth Circuit has shifted away from a disclosure standard and replaced it with a new duty "to insist on compliance."

In total contradiction of the Sixth Circuit's opinion, two district courts have held that an attorney has an obligation to correct or disclose known material misrepresentations and omissions.

In *SEC v. National Student Marketing Corp.*, 457 F. Supp. 682 (D.D.C. 1978), National Student Marketing Corp. ("NSMC"), entered into an agreement with Interstate National Corporation ("INC") to acquire all of INC's shares in exchange for NSMC shares. At the closing, counsel for INC were given an unsigned "cold comfort" letter from NSCM's accountants that disclosed material adverse changes in NSMC's financial condition. The attorneys for INC proceeded to close the merger with NSMC without disclosing the material adverse changes to ICS shareholders. The Court held the attorneys liable as aiders and abettors on the grounds they had a duty to disclose. 457 F. Supp. 682, 713.

Similarly, in *Rose v. Arkansas Valley Environmental and Utility Authority*, 562 F. Supp. 1180, 1207-08 (W.D. Mo. 1983), the Court held an attorney could be liable as an aider and abettor for violating a "duty to correct" a bond opinion after he learned of omissions and misrepresentations in his opinion.

Like the Sixth Circuit opinion, these cases did not attempt to analyze Congressional intent. Indeed, the finding of secondary liability against the attorneys in *National Student Marketing Corp.* has been criticized as "no longer viable in light of recent Supreme Court decisions strictly interpreting the federal securities laws." Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 Cal. L. Rev. 81, 82, 104-05 (1981). Further, the *National Student Marketing* decision has been criticized as only adding confusion because it did not indicate what steps an attorney should take to effect disclosure nor at what point in a securities transaction attorneys should take such steps. Goldstrom, *Secondary Liability of Attorneys for Securities Law Violations —— The Need For a Single Standard of Attorney Conduct*, 30 Wayne L. Rev. 65, 72 (1983). This Court's guidance is needed to reconcile the conflict among the few existing cases on point and the criticisms to which each are susceptible.

The void of legal opinion that currently exists is particularly troublesome because of the unique role of the securities attorney. Often, the securities attorney is called upon to choose between (1) his duty, imposed by the American Bar Association's Code of

Professional Responsibility (Code) or Model Rules of Professional Conduct (Model Rules), to zealously represent his client and protect his client's confidences and secrets, and (2) his duty, advocated by the SEC, to give primary allegiance to the investing public. Without a decision by this Court, the securities attorney will remain confused as to what his proper duty is under the federal securities law.

In recent years, the SEC has advocated the position that a securities attorney must assist in maintaining the honesty and integrity of the securities market, even if that means that the attorney must disclose his client's privileged communication. Garrett, *New Directions In Professional Responsibility*, 29 Bus. Law 7 (Mar. 1974).

In paragraph 48(i) of its *National Student Marketing* complaint, for example, the SEC alleged that the defendant-attorneys were liable as aiders and abettors:

> As part of the fraudulent scheme [counsel] failed to . . . insist that the financial statements be revised and shareholders be resolicited, and failing that, to cease representing their respective clients, and, under the circumstances, notify the plaintiff Commission . . . " *SEC v. National Student Marketing Corp.*, No. 225-72 [1971 - 1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) paragraph 93, 360 (DDC filed Feb. 3, 1972).

In other pronouncements, the SEC has stated that "we must keep the pressure on the professionals to do a major part of the job —— the protection of the investors." *See*, Garrett, *New Directions in Professional Responsibility*, 29 Bus. Law 7 (Mar. 1974); *see also*, *Morris MacSchwebel*, 40 SEC 347 (1960)

On the other hand, the securities attorney must balance the duties imposed on him by the Code and Model Rules to zealously represent his client and protect his client's confidences and secrets.

Under the Code, there is only one situation where an attorney must subordinate the general duty to protect his client's confidences and secrets. DR 7-102(B) (1) describes the situation where a client's securities violation *must* be disclosed:

> (B) A lawyer who receives information clearly establishing that:
>
> (1) His client has, in the course of the representation, perpetrated a fraud upon a person or tribunal, shall promptly call upon his client to rectify the same, and if his client refuses or is unable to do so, he shall reveal the fraud to the affected person or tribunal, except when the information is protected as a privileged communication.

DR 7-102(B)(1), however, is severely limited by other disciplinary rules and ABA statements of policy. In 1975, the ABA House of Delegates found that an attorney should not correct or disclose a client's fraudulent acts in accordance with DR 7-102(B)(1) unless the attorney is sure beyond a reasonable doubt that the fraud has been committed. Moreover, DR 7-102(B)(1) excepts "privileged communications" from its disclosure requirements. "Privileged communications" has been defined as a client's confidences and secrets that are required to be protected under DR 4-101 without regard to the nature or source of the information or the fact that others share the knowledge.[1] ABA Comm. on Ethics and Professional Responsibility, Formal Op. 341 (1975).

DR 7-102(B)(1) has some effect only because under DR 4-101(C), an attorney is permitted to reveal his client's con-

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[1]Model Code of Professional Responsibility DR 4-101(B) provides as follows:

(B) Except as permitted by DR 4-101(C), a lawyer shall not knowingly:

(1) Reveal a confidence or secret of his client.

(2) Use a confidence or secret of his client to the disadvantage of the client.

(3) Use a confidence or secret of his client for the advantage of himself or of a third person, unless the client consents after full disclosure.

fidences in certain limited circumstances.[2] Even then, however, disclosure is optional. Thus, DR 7-102(B)(1) is severely limited, leaving the securities attorney with his general duty under DR 4-101 to protect his client's confidences and secrets.

Overall, a securities attorney's duty imposed by the Code to protect his client's confidences and secrets remains in conflict with the SEC's position that an attorney owes his primary allegiance to the investing public. Indeed, the ABA has recognized this conflict and concluded that the "vital confidentiality of [a lawyer's] consultation and advice would be destroyed or seriously impaired if it is accepted as a general principle that lawyers must inform the SEC or others regarding confidential information received by lawyers from their clients . . ." *Statement of Policy Adopted by American Bar Association Regarding Responsibilities and Liabilities of Lawyers in Advising with Respect to the Compliance by Clients with Laws Administered by the Securities Exchange Commission*, 31 Bus. Law 543, 544 (Nov. 1975)

The conflict with the SEC's position is no less apparent under the more recent Model Rules of Professional Conduct adopted by the ABA in 1983. The Model Rules actually go further than the Code in protecting an attorney's general duty to preserve his client's confidences.[3] Under Rule 1.6 the scope of matters considered confidential has been expanded to apply to all information relating to the representation. Most importantly, Rule 1.6(b)(1) does not even **permit** disclosure of a client's securities fraud unless 1) the client consents or authorizes disclosure, 2) the attorney needs to disclose the fraud in order to establish a claim or defense in a controversy between himself and the client, or 3) disclosure is necessary to prevent substantial bodily harm or imminent death.

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[2]Model Code of Professional Responsbility DR 4-101(C) provides:

A lawyer may reveal:

(1) Confidences or secrets with the consent of the client or clients affected, but only after a full disclosure to them.

(2) Confidences or secrets when permitted under Disciplinary Rules or required by law or court order.

(3) The intention of his client to commit a crime and the information necessary to prevent the crime.

(4) Confidences or secrets necessary to establish or collect his fee or to defend himself for his employees or associates against an accusation of wrongful conduct.

[3]MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6 (1983) provides:

The decision to strengthen the requirement of confidentiality in the Model Rules was not made lightly. It was a result of continuous and heated debate over the Discussion Draft of the Model Rules put forth by the Kutak Commission in 1980. The Discussion Draft had adopted much of the SEC approach, broadening the scope of mandatory and permissive disclosure by attorneys of matters shielded as confidential under the Code. The resulting backlash of responses and criticisms was overwhelming. *See*, Walter, *An Overview of the Model Rules of Professional Conduct*, 24 Washburn L.J. 443, 456 (1985); Kutak, *Chairman's Introduction to Rules* (Proposed Final Draft 1981), *reprinted in* 67 A.B.A. J. 1229 (1981); *Review Symposium: The Model Rules of Professional Conduct*, 1980 AM. B. Found. Research J. 921, 981 (1980).

To many attorneys, the Discussion Draft's adoption of the SEC approach was seen as eroding "basic constitutional protections by making the lawyer the agent of the state, not the champion of the client, in many important respects." *The Roscoe Pound —— American Trial Lawyer's Foundation Commission on Professional Responsibility, American Lawyer's Code of Conduct* (Discussion Draft 1980). The debate and criticism proved effective, for by the time the Model Rules were adopted by the ABA in 1983, Rule 1.6 bore little resemblance to its counterpart in the heavily criticized Discussion Draft. Thus, after careful consideration, the ABA has totally rejected the SEC position.

In sum, the securities attorney is faced with two irreconcilable interests: 1) the desire to avoid SEC prosecution and private actions under the federal securities laws for failing to

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(Footnote 3 continued)

(a) A lawyer shall not reveal information relating to representation of a client unless the client consents after consultation, except for disclosures that are impliedly authorized in order to carry out the representation, and except as stated in paragraph (b),

(b) A lawyer may reveal such information to the extent the lawyer reasonably believes necessary:

(1) To prevent the client from committing a criminal act that the lawyer believes is likely to result in imminent death or substantial bodily harm; or

(2) To establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client

protect society's interest in assuring that innocent third parties are not victimized, and 2) the desire to act in accordance with legal professional standards that demand the protection of a client's confidences.

This Court can eliminate the conflict by granting this petition for writ of certiorari and determining whether an attorney has a duty to disclose or correct known misstatements and omissions in offering circulars he has prepared. Because this case is one of first impression, this Court has the opportunity to write on a clean slate in setting a uniform federal standard. *See,* Goldstrom, *Secondary Liability of Attorneys for Securities Law Violations —— The Need for a Single Standard of Attorney Conduct,* 30 Wayne L. Rev. 65, 65 (1983) ("The solution to this dilemma is a singe set of guidelines upon which the securities bar may rely.")

CONCLUSION

In this case, the Sixth Circuit scoured the record in an effort to find circumstantial evidence that conflicted with the jury's verdict. Such a standard of appellate review is clearly contrary to this Court's decision in *Lavender* and numerous other FELA cases. But the United States Courts of Appeals, including the Sixth Circuit itself, are in a state of conflict and confusion, not knowing whether this Court intended for its FELA decisions to apply in a non-FELA action.

Similarly, the lower federal courts and the securities bar need this Court's guidance in order to establish a uniform rule regarding an attorney's duty under the federal securities laws to correct known misstatements and omissions of material fact in offering circulars he has prepared.

This petition for writ of certiorari should be granted so that this Court can give its badly needed guidance on these crucial issues.

Respectfully submitted,

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RECOMMENDED FOR FULL TEXT PUBLICATION
See, Sixth Circuit Rule 24

Nos. 85-3520, 85-3550, 85-3551

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

FRANKLIN MOORE; JULIA A. MOORE, on behalf of themselves and a class of persons similarly situated,
Plaintiffs-Appellants, Cross-Appellees, (85-3520)

v.

FENEX, INCORPORATED, et al.,
Defendants,

WILLIAM WEST,
Defendant-Appellee, Cross-Appellant, (85-3551)

and

EARLE R. FROST, JR. and BROWNFIELD, BOWEN, BALLY & STURTZ,
Defendants-Appellees, Cross-Appellants, (85-3550).

ON APPEAL from the United States District Court for the Southern District of Ohio.

Decided and Filed January 14, 1987

Before: MARTIN, GUY and NORRIS, Circuit Judges.

GUY, Circuit Judge. Defendants Earle R. Frost, Jr., Brownfield, Bowen, Bally & Sturtz and William West appeal, and plaintiffs cross-appeal, judgment entered upon a jury verdict in this securities case. The case was brought as a class action under the Securities Exchange Act of 1934, 15 U.S.C. § 78 *et seq.*, the Ohio Securities Act, Ohio Rev. Code §§ 1707-41, 1707.43 and 1707.44, and Ohio common law claims of fraud and breach of fiduciary duty. After a lengthy jury trial, a verdict was returned in favor of plaintiffs on all counts. We reverse the judgment as to defendants Frost and Brownfield, and affirm as to defendant West. We also affirm as to the issues raised by plaintiffs.

The facts adduced at trial are rather complicated. Defendant Fenex, Inc., is an Ohio corporation organized in 1976 for the purpose of issuing and selling to the public joint venture interests in drilling various oil and gas wells in Ohio, primarily in Holmes, Perry, and Wayne Counties. HMW Company, Inc., a related organization, is an Ohio corporation organized in 1977 for the purpose of issuing and selling to the public limited partnership interests in oil and gas drilling equipment for specified oil and gas wells in this same area. Because Fenex and HMW are involved in Chapter 7 bankruptcy proceedings, this action was stayed as against them. Bethel Securities, Inc., is an Ohio corporation organized in 1978 to act as the sales arm of Fenex and HMW. A related non-party is Bethel Resources, Inc., the operating arm of the company, also currently involved in bankruptcy proceedings. These companies will be referred to by individual name or as the Bethel Group.

The Bethel Group companies were related by stock ownership, directorship and officers. As a group they were controlled by defendants Robert R. Hills and Rufus B. Hurst. Defendant William West was employed by Bethel Securities as a salesman selling HMW and Fenex programs from September, 1976 until February, 1981. In addition, West was elected to the Board of Directors of HMW in late November,

1980 and served until September of 1981. Defendant Frost was a partner in defendant law firm, Brownfield, Bowen, Bally & Sturtz. Between 1976 and approximately August or September of 1981, the Brownfield firm, through Earle R. Frost, represented the Bethel Group in all its dealings with the Ohio Division of Securities.

The plaintiff class consisted of all purchasers of Fenex oil and gas interests and HMW equipment ventures sold by Bethel Securities between mid-1976 through 1981. Plaintiffs alleged that during this time, defendants sold securities to the public in various oil and gas drilling programs and well equipment ventures. Plaintiffs' position was that basic representations in the offering circulars were false. The gravamen of their complaint was that defendants knew, or should have known, or intentionally remained ignorant of, the following material facts: (1) plaintiffs' investments were used as cash flow for the Bethel Group rather than the specific drilling programs and equipment ventures described in the offering circulars; (2) plaintiffs' oil and gas wells were not drilled in accordance with the timetables represented in the Fenex offering circulars; (3) contrary to express representations in the HMW offering circulars, plaintiffs' investments were transferred to Bethel Resources; (4) as a result of undertaking contractual obligations to drill about 75 oil and gas wells for an unrelated third party, the Bethel Group's problems in drilling and equipping oil and gas wells increased and magnified; and (5) through the use of "the sheet," the plaintiff class' investment funds were moved and shuffled between and among the companies in the Bethel Group and used for improper purposes, as a result of which plaintiffs' wells were not drilled and plaintiffs' equipment was not purchased. Plaintiffs alleged that none of the Bethel Group's operational, accounting and drilling difficulties or shuffling of investors' funds were revealed to past, present or potential investors. Rather, in an attempt "to play catch up" and to continue to generate funds to meet an increasing cash flow problem aggravated by rapidly spiraling inflation in the industry and exac-

erbated by the removal of investors' funds for improper purposes, as well as a complete lack of accounting and management controls and procedures, defendants continued to solicit funds from the public to cover past and current obligations. Plaintiffs sought $7.2 million, their total investment in the programs.

Claims Against Frost and the Brownfield Firm

I.

Defendant Frost, a partner in defendant law firm Brownfield, Bowen, Bally & Sturtz, prepared the offering circulars of Fenex and HMW. Plaintiffs set forth two types of misconduct against these defendants: that defendants made a material misrepresentation in the circulars by stating that funds collected for different well programs would be segregated and used only for that particular well; and that defendants omitted a material fact in that they failed to disclose the precarious financial position of the companies.

The trial court essentially granted a partial directed verdict in favor of defendants as to all circulars prepared before September 25, 1980. It was established at trial that Frost had no knowledge of wrongdoing before that time. After that date, seven circulars were prepared by defendants, four of which were offered by HMW Company and three of which were offered by Fenex. (*See* Joint Appendix, Stipulated Facts, Pre-Trial Order). The last offering, issued in September, 1981, was rescinded on the advice of defendant Frost and the money was refunded to the investors. Consequently, the preparation of six offering circulars was the basis for the jury's finding of liability against these defendants.

Defendants Frost and the Brownfield firm were found liable on claims of federal securities law violations, Ohio common law fraud and breach of fiduciary duty. Defendants have challenged the jury's verdict as to each of these claims.

A.

Defendants Frost and the Brownfield firm challenge the finding of liability for breach of fiduciary duty in two ways. First, defendants contend that this issue was not properly pleaded against them and should not have been submitted to the jury. Second, defendants argue that they owed no fiduciary duty to the plaintiff investors.

It is undisputed that in count six of their complaint, plaintiffs set forth a claim for relief for breach of fiduciary duty against Fenex, HMW, Bethel Securities, and defendants McQueen and Hills. Frost and the Brownfield firm were not named in that count. Nevertheless, plaintiffs contend that the final pre-trial order controls the course of the trial, and that defendants were put on notice that an Ohio common law claim for breach of fiduciary responsibilities was asserted against them.

We note initially that this is not a case in which a plaintiff may argue that the issue was tried by consent of the parties. Our review of the record reveals no indication that defendants were or should have been aware that breach of fiduciary duty was actually being tried as against them. Accordingly, Fed. R. Civ. P. 15(b), permitting amendment of pleadings by implied consent, does not apply.

Issues incorporated in a pre-trial order may supersede the pleadings. *Howard v. Kerr-Glass Mfg. Co.*, 699 F.2d 330, 333 (6th Cir. 1983). The question then is whether the pre-trial order put the defendants on notice that they were being charged with breach of fiduciary duty. We are unable to conclude that it did.

The section of the pre-trial order that plaintiffs point to is the section entitled "Nature of Action and Jurisdiction." This section states:

> This is a class action for compensatory damages arising under the Securities Exchange Act of 1934, as

> amended (the "1934 Act"), 15 U.S.C. § 78, *et seq.*, the Ohio Securities Act, Ohio Revised Code §§ 1707.41, 1707.43 and 1707.44 (the "Ohio Act"), and Ohio common law claims of fraud and breach of fiduciary responsibilities. Plaintiffs also assert claims for punitive damages, which Defendants assert are not properly pleaded.

This section goes on to describe jurisdiction and venue, and the class nature of the action. Two sections later, plaintiffs' statement of the case is described, and the actions and positions of each of the defendants are generally set forth.

We cannot conclude that this pre-trial order would put Frost and the Brownfield firm on notice that claims advanced against other parties in the complaint were now being brought against them as well. The section plaintiffs rely on generally describes the claims set forth in the complaint; it does not indicate against whom those claims are being asserted. Furthermore, the order did not indicate that the complaint was being amended. There is no basis on which to hold that defendants should ignore a well-pleaded complaint and rely instead on a very general description of claims being asserted against multiple defendants, especially in the absence of a motion to amend or any other indication that all claims were now being asserted against them.

Plaintiffs also assert that even if not properly pleaded, defendants suffered no prejudice by submitting the breach of fiduciary duty claim to the jury. They contend that the jury's verdict demonstrates that neither Frost nor his firm could counter the evidence introduced on this issue. We find this rather circular reasoning to be without merit.

Under Ohio law, a fiduciary relationship, such as that alleged here, may be created out of an informal relationship, but this is done only when both parties understand that a special trust or confidence has been reposed. *Umbaugh Pole Bldg. Co., Inc. v. Scott*, 58 Ohio St. 2d 282, 390 N.E.2d 320,

321 (1979). Because Frost and his firm were not on notice that breach of fiduciary duty was being raised against them, they had no reason to question the investor plaintiffs who testified as to their understanding of such relationship, if any. This information was critical to a reasoned defense of breach of fiduciary duty against Frost and the Brownfield firm.

Accordingly, it was error for the trial court to submit this improperly pleaded issue to the jury when defendants Frost and the Brownfield firm had no notice that this claim would be advanced against them and were prejudiced by such lack of notice. Consequently, the jury's verdict on this claim must be reversed.[1]

B.

Defendants Frost and the Brownfield firm next challenge the jury's finding of liability for common law fraud. First, defendants assert that the trial court erred in denying their motion for directed verdict and judgment n.o.v. on this issue. Second, defendants challenge the court's instruction on liability for failure to disclose a material fact.

In Ohio, the elements of fraud are as follows: (1) There must be an actual or implied representation of a matter of fact; (2) which relates to the present or past, (3) which was material to the transactions, and (4) which was false when made. (5) The statement must be made with knowledge of its falsity, or with reckless disregard for whether it is true or not and (6) with the intent to mislead the other party into relying on it. (7) The other party must be ignorant of the fact

[1] Our review of the record also leaves us in serious doubt that this claim could be maintained against these defendants. We think that like the *Umbaugh* case, plaintiffs, under the circumstances presented here, had no reasonable expectation that these defendants were acting on their behalf. Plaintiffs have failed to point to any case where Ohio common law extends a fiduciary duty in like circumstances. The cases they do rely on, dealing with federal securities law, are irrelevant to this issue.

averred, causing (8) justifiable reliance and (9) injury. *Dunn Appraisal v. Honeywell Information Systems*, 687 F.2d 877, 882 (6th Cir. 1982).

Plaintiffs' first claim of fraud was that defendants misrepresented in the offering circulars that the funds invested would be segregated for use for the particular well offered. The evidence presented at trial indicates that Frost was told for the first time on August 28, 1980, that *Fenex* funds had been comingled into a cash management account. At that time, Frost insisted that the offerings currently "on the street" and all future offerings have separate accounts set up. He periodically checked the passbooks for these accounts to assure their continued use. Two of plaintiffs' witnesses supported Frost's testimony, and in fact indicated that Robert Hills, the manager of the companies, instructed them not to tell Frost that Fenex funds had been comingled. After September 28, 1980, the funds were kept in separate accounts until sometime in the late spring of 1981 when apparently, investors' funds were used for purposes other than drilling of their wells. Plaintiffs' witness, the accountant for the companies, testified that she was instructed not to tell Frost that funds were again being diverted for other uses.

The accountant also testified, and again this testimony was undisputed, that HMW funds had always been kept segregated and were not comingled in a cash management account until the late spring of 1981. At that time, although separate accounts were still maintained, the funds were apparently being diverted to uses other than that for which they were designated.

In short, the undisputed testimony at trial indicated that for the last six offering circulars in question, the funds invested were kept in separate accounts at the direction of Frost. It is also undisputed that Frost checked to assure the continued maintenance of separate accounts, and that when the funds were finally diverted, this information was kept from him. Accordingly, as to this claim, an essential element

of fraud is absent: the representation that the funds invested would be separately maintained was not false.

The other allegation of fraud dealt with Frost's non-disclosure of the companies' financial troubles. Of the six offering circulars in issue, four of them dealt with HMW limited partnerships. Plaintiffs' witness, Rufus Hurst, the head of Bethel Resources, testified that at the time he revealed that Fenex funds had been comingled, Frost asked whether HMW funds were involved. Hurst told him that there were no problems with HMW. In early October of 1980, Hurst informed Frost that Fenex was short of funds to complete their well obligations. There was no indication that HMW was experiencing like problems. In the fall of 1980, Hurst undertook to determine the amount of Fenex's shortfall. There is documentary evidence of Hurst's efforts to calculate this amount; none of these documents implicate HMW. In fact, there is no evidence in the record that HMW was, at that time, experiencing financial problems. Accordingly, there was no evidence that Frost failed to disclose a material fact with regard to the HMW offerings.

Of the two Fenex offerings issued after September 25, 1980, the last, issued February 3, 1981, stated that the company was experiencing serious cash flow problems and was attempting to obtain a loan to remedy the situation. As to this circular then, the fact of financial difficulties was disclosed.

The remaining circular was the Fenex offering issued on December 9, 1980. Frost learned in early October that Fenex was short of money to finish its well obligations. At that time, Rufus Hurst began his attempts to determine the amount of money Fenex was short. He subsequently determined that $709,000 was necessary to finish the Fenex wells. When Frost learned that Fenex was experiencing cash flow problems, he reported that information to the Ohio Division of Securities. In the meantime, a loan was being negotiated with the Pittsburgh National Bank. On November 17, 1980, the bank sent

a written commitment to loan at least $500,000, and possibly up to $1 million to Fenex. With the loan from the Pittsburgh bank and expected receipt of accounts receivable on a drilling contract with a third party, Hurst testified that by the end of November both he and Frost believed that the financial problem had been resolved. After these events, the Ohio Division of Securities gave the go ahead for further offerings.

We review the grant or denial of a directed verdict by the trial court under the same standard used by that court in determining whether or not it was appropriate to grant the motion:

> In considering a motion for a directed verdict under rule 50(a), the trial court "must determine whether there was sufficient evidence presented to raise a material issue of fact for the jury." *O'Neill v. Kiledjian*, 511 F.2d 511, 513 (6th Cir. 1975). As applied in this context, "sufficient evidence" is such that, when viewed in the light of those inferences most favorable to the nonmovant, . . . there is either a complete absence of proof on the issues or no controverted issues of fact upon which reasonable [minds] could differ. *O'Neill*, 511 F.2d at 513.

Sawchik v. E.I. Dupont Denemours & Co., 783 F.2d 635, 636 (6th Cir. 1986).

We are convinced, after a careful and extensive review of the record, that reasonable minds could reach but one conclusion. There was no evidence of fraud as to the segregation of funds since the evidence indicated that the funds were, in fact, segregated at the relevant times. As to nondisclosure of financial condition, the undisputed evidence showed that by the time of the December 9, 1980 Fenex offering, all of the relevant parties involved felt that the problem had been solved. The documentary evidence supports this conclusion, i.e., commitment letter from the Pittsburgh Bank, and approval by the Ohio Division of Securities.

We do not believe that from this evidence reasonable minds could conclude that Frost intended to commit fraud. While plaintiffs would have us draw an inference of fraud from the ultimate collapse of the companies, all of the testimony and other evidence indicating what Frost knew, and how he acted on that information is to the contrary. Accordingly, we find that the trial court erred in failing to grant a directed verdict in favor of Frost and the Brownfield firm on the issue of fraud.[2]

C.

Defendants Frost and the Brownfield firm next contend that the trial court erred in denying their motions for directed verdict and judgment n.o.v. on the issue of § 10b-5 liability under federal securities law. Section 10b-5 is directed against false statements and omissions of material fact in connection

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[2] There was some dispute as to whether negligence will support a finding of fraud for failure to disclose under Ohio law. In fact, relying on *Miles v. McSwegin*, 58 Ohio St.2d 97, 388 N.E.2d 1367 (1979), the trial court instructed the jury that "a party is under a duty to speak, and therefore liable for non-disclosure, if the party fails to exercise reasonable care to disclose a material fact which may justifiably induce another party to act or refrain from acting, and the non-disclosing party knows that the failure to disclose such information to the other party will render a prior statement or representation untrue or misleading." 388 N.E.2d at 1369. The problem with giving this instruction is that *Miles* was a case claiming *fraudulent nondisclosure*, a separate theory from fraud. This is clearly illustrated by the Ohio Supreme Court's reliance on Restatement of Torts 2d, § 551. This section sets forth the elements of recovery for a claim of "fraudulent nondisclosure." First of all, the plaintiffs herein alleged a cause of action for fraud; there was never any allegation for the separate claim of fraudulent nondisclosure. Secondly, we doubt whether the claim of fraudulent nondisclosure is viable against Frost and Brownfield. The cases illustrate, and the Restatement supports, that this claim applies between parties to a business transaction. We are aware of no case, nor has any been cited, where a party has been held liable for fraudulent nondisclosure that had no direct dealings with the plaintiff. We believe this theory has no application to Frost and his firm.

with securities sales and purchases. Defendants were found liable on an aider and abettor theory. Usually, "a person may be held as an aider and abettor only if some other party has committed a securities law violation, if the accused party had general awareness that his role was part of an overall activity that is improper, and if the accused aider-abettor knowingly and substantially assisted the violation." *Securities & Exch. Com'n v. Washington County*, 676 F.2d 218, 224 (6th Cir. 1982) (citing *Securities & Exchange Com'n v. Coffey*, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975)).

As to the third requirement, the analysis required by this factor must be particularly exacting in cases involving non-disclosure. *Washington County*, 676 F.2d at 226. The plaintiffs must show that the silence of the accused aider and abettor "was consciously intended to aid the securities law violation," and must prove either a culpable state of mind, or conduct from which a culpable state of mind can be inferred. *Id.*

For much the same reasons as set forth in part B, we think these defendants were entitled to a directed verdict on this issue. Plaintiffs have failed to make any showing that defendant Frost consciously intended to aid a securities fraud violation. Frost's conduct, far from showing a culpable state of mind, indicates the contrary. Moreover, the evidence as to what Frost knew, when he knew it, and what he believed about the financial state of the companies is, as noted above, undisputed even by plaintiffs' own witnesses.

On this securities claim, plaintiffs have also alleged that these defendants were liable for nondisclosure of the fact that, in the past, Fenex had failed to segregate funds. However, the uncontroverted evidence demonstrated that when Frost discovered this fact, he first informed the Ohio Division of Securities, directed his clients to segregate all incoming and future funds, and periodically checked the accounts to assure that his advice was being followed. We fail to see how these facts could lead one to conclude that Frost consciously

intended to aid a securities law violation. No inference of a culpable state of mind can legitimately be drawn from such conduct.

Accordingly, Frost and the Brownfield firm were entitled to a directed verdict on this claim as well. In light of the reversal of liability on the part of Frost and Brownfield, we need not address the other claims they raise.

Claims Against West

II.

Defendant William West appeals from the judgment entered below finding him liable for violations of federal securities law and Ohio securities law, and for common law fraud and breach of fiduciary duty. West was a salesman for HMW and Fenex securities. He also served briefly on the Board of Directors of HMW, from November, 1980 to October, 1981.

As to federal securities law violations, West was found liable both as a primary violator and as an aider and abettor. The jury found that West was not liable as a "controlling person" under § 20 of the Securities and Exchange Act of 1934.[3] West first complains that the only allegation contained in the complaint against him on federal securities law grounds was that he was a "controlling person." West therefore asserts that it was error to submit to the jury the claims of primary and secondary liability.

We must reject this argument for two reasons. First, West failed to object to the submission of these claims to the jury. Secondly, West was not prejudiced by the submission of these claims. Although we recognize that whether one is a

[3] Under § 20 of the Securities and Exchange Act of 1934, a person who "controls" a person who violated the securities law, is liable to the same extent as the controlled person.

"controlling person" within section § 20 of the 1934 Act implicates different concerns than primary and secondary security law violations, West actually defended against all three claims. His position throughout trial was that he had never misrepresented material facts or failed to disclose material facts. He also continually asserted that he was unaware of any wrongdoing, and that he had no knowledge as to the financial dealings of the companies. Accordingly, it was not plain error for the court to submit these claims to the jury. Fed. R. Civ. P. 51.

West next complains that the trial court erred in failing to direct a verdict on all four grounds of liability: federal securities law violations, Ohio securities law violations, Ohio common law fraud and breach of fiduciary duty. These findings of liability were apparently based on the fact that after West became a director of HMW Company, he sold one last offering. Plaintiffs' alleged that at that time, February of 1981, West had knowledge that HMW Company was experiencing financial and management problems. In support of this allegation, plaintiffs presented West's notes of topics he wanted to discuss at a Board of Directors meeting held February 2, 1981. In these notes, West stated:

> Now we are behind in all phases. Some of the causative factors are:
>
> | | |
> |---|---|
> | Cost-overruns | Poor to non-existent |
> | Mis-management | follow up. |
> | Lack of control | Lack of priorities |
> | Poor planning | Lack of direction |
> | Mis-directed activities | Incompetent personnel |
> | Loss of time | Lack of sales 1981 |

West also stated that "the company has been reduced to the struggling, grasping monster with which we are now faced, and with which, we are willing to attempt to put some semblence of business identity and honesty of operation back into its workings and influence."

BEST AVA

Although the evidence against West cannot be characterized as overwhelming, drawing legitimate inferences in favor of plaintiffs, we believe there was conflicting evidence from which the jury could find West liable.[4]

By selling the securities with knowledge of their falsity, West would be liable under § 10b-5 as a primary violator, since he would have directly participated in the deceit. Likewise, these facts would support aider and abettor liability as well; that is, that a primary violation had occurred, and that West had general awareness that his role was part of an overall activity that was improper, and that he knowingly and substantially assisted the violation.

Ohio Rev. Code § 1707.41 provides for civil liability for fraud of a seller of securities:

> [A]ny person who, by a written printed circular, prospectus, or advertisement, offers any security for sale . . . is liable, to any person who purchased such security relying on such circular, prospectus, or advertisement, for the loss or damage sustained by such relying person by reason of the falsity of any material statement contained therein or for the omission therefrom of material facts, unless such offeror. . . establishes that he had no knowledge of the publication thereof prior to the transaction complained of, or had just and reasonable grounds to believe such statement to be true or the omitted facts to be not material. . . .

---

[4] On appeal, West has asserted that the last offering he sold to the Moores was a Fenex offering and not a HMW offering. However, at trial, West testified that the last offering he sold was a HMW offering. The Moores testified that it was either a Fenex offering or a HMW offering. Thus, the evidence on this issue was, at trial, in conflict. Accordingly, the jury was free to find that the last offering West sold was a HMW security and that West was liable.

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Because there was evidence presented that plaintiffs relied upon the representations of West, in addition to the other testimony noted above, there was sufficient evidence presented for the jury to find West liable for Ohio security law violations.

West also asserts in a conclusory manner that he could not be liable for common law fraud or for breach of fiduciary duty. However, a review of the elements of fraud, recited above, indicates that this evidence does support a finding that the last sale of securities by West constituted fraud. Likewise, since West admits that he owed a fiduciary duty to investors, this evidence also supports a finding that he breached that duty. Although West points to conflicting evidence in the record to indicate that he lacked specific knowledge of wrongdoing and that he acted in good faith, because there is some evidence from which a jury could find liability the trial court did not err in denying West's motion for a directed verdict.

Accordingly, the judgment of the district court as to defendant West is affirmed.

Cross Appeal of Plaintiffs

III.

Plaintiffs cross-appeal raising three issues. First, plaintiffs assert that the trial court erred in directing a verdict in favor of Frost and Brownfield as to offering circulars issued prior to September 25, 1980. Plaintiffs urge that there was sufficient evidence from which a jury could conclude that Frost and Brownfield were liable as primary securities law violators or as aiders and abettors.[5]

[5]At trial, plaintiffs apparently only proceeded against Frost and Brownfield on an aider and abettor theory. It is unclear why they now assert primary liability against these defendants. In any event, since we find no liability on either theory, the issue is irrelevant.

Plaintiffs sought to establish that Frost was aware of financial difficulties and mismanagement within the Bethel Group prior to September, 1980. To that end, they offered into evidence the following: (1) a letter from Frost in July, 1977, criticizing Robert Hills and Rufus Hurst for the "slipshod" work in connection with assembling certain information needed for an offering; (2) three items of evidence indicating problems with leases; (3) an item indicating that Fenex did not pay the delay rentals on a lease and therefore had to obtain ratification of the lease prior to drilling; and (4) evidence of untimely filing of tax returns.

The trial judge described the inference that these documents indicated that Frost was aware of fraud as a "quantum leap." We agree. In fact, the evidence adduced at trial, from plaintiffs' own witnesses, was that Frost was kept in the dark as to the financial dealings of Fenex and Bethel Resources until the Fall of 1980. The information relied on by plaintiffs simply does not support an inference of knowledge of the type of fraud which was later revealed. Accordingly, the trial court did not err in granting the directed verdict.

IV.

Plaintiffs next argue that the trial court erred in ruling, as a matter of law, that Frost was under no duty to correct the offering circular most recently issued when he learned that Fenex had failed to segregate investors' funds. The trial court held that Frost and his firm could not be liable for misrepresentations or omissions in those offering circulars although Frost learned of them while they were being sold to investors.

Plaintiffs rely on *SEC v. National Student Marketing Corp.*, 457 F. Supp. 682 (D.D.C. 1978). In that case, attorneys for Interstate National Corporation were charged with aiding and abetting a securities law violation for failure to interfere in the consummation of a merger between Interstate and National Student Marketing Corporation (NSMC) once they learned that NSMC's financial situation was not as repre-

sented. The court held, at the least, that these defendants were required to speak out at the closing concerning the information they acquired, and advise their client that the merger not be closed until the information was disclosed and the merger again approved by Interstate shareholders.

In the instant case, we see no need to establish a hard and fast rule that an attorney has a duty to correct an offering circular when the attorney learns of a misrepresentation contained in the circular. Here, it is undisputed that Frost insisted that the funds collected at that time be maintained in separate accounts. Moreover, he periodically checked to make sure that the funds were being properly held. It is also uncontrovered that the funds collected from this offering and subsequent offerings were maintained as represented until the late spring or summer of 1981. In other words, rather than advising his clients to correct the offering circular, Frost insisted that his clients comply with the representations made in the offering circulars. Accordingly, we decline to hold Frost liable under these circumstances.

V.

Plaintiffs' last claim is that the trial judge erred in failing to hold Frost and Brownfield jointly and severally liable with the other defendants on the state and federal securities fraud claims. Because we have reversed the finding of liability against Frost and Brownfield, we need not address this claim, and we express no opinion on the trial court's treatment of damages.

The judgment of the district court is REVERSED as to defendants Frost and Brownfield, Bowen, Bally & Sturtz, and AFFIRMED as to defendant William West and as to the claims raised by plaintiffs.

STATUTES AND CONSTITUTIONAL PROVISIONS

Amendment 7 to the United States Constitution

In Suits at common law, where the value in controversy shall exceed twenty dollars, the right of a trial by jury shall be preserved and no fact tried by a jury, shall be otherwise re-examined in any Court of the United States, than according to the rules of the common law.

5 U.S.C. § 78j Manipulative and Deceptive Devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange ——

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

§240.10b-5 Employment of Manipulative and Deceptive Devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Supreme Court, U.S.
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No. 86-1745

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1986

FRANKLIN AND JULIA MOORE,
individually and as representatives of a class,
Petitioners,

v.

EARL R. FROST, JR. AND
BROWNFIELD, BOWEN, BALLY & STURTZ,
Respondents.

RESPONDENTS' BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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OPINIONS BELOW

The opinion of the Court of Appeals for the Sixth Circuit is reported at 809 F.2d 297 and is reprinted in Appendix A to the Petition for a Writ of Certiorari herein.

STATEMENT OF THE CASE

A. Proceedings Below

The statement of proceedings below which appears on pages 1 and 2 of the Petition for a Writ of Certiorari filed herein is complete and accurate.

B. Statement of Facts

This case involves the activities of four Ohio corporations relating to the syndication of joint venture interests and limited partnerships in oil and gas programs in eastern Ohio during the period of 1976 through 1981. Fenex, Inc. ("Fenex") was an Ohio corporation organized in 1976 and operated as a joint venturer with various investors in oil and gas wells (Final Pretrial Statement, Stipulation of Facts ("Stipulation"), R. 123 at 11). Fenex, and the investors who joined with it in a joint venture, owned intangible working interests in oil wells, which amounted to approximately 54.76% of the income from the well (T.P., R. 193 at 525).

H.M.W. Company, Inc. ("H.M.W.") was an Ohio corporation organized in 1977. It entered into limited partnership agreements with investors in oil and gas well equipment. This equipment frequently was placed on Fenex wells in return for a portion of the production income (T.P., R. 193 at 522; 533).

Bethel Securities Company was a registered broker dealer which sold the securities issued by Fenex and H.M.W. Bethel Resources, Inc. was an affiliated contractor primarily employed to drill the wells and purchase the equipment (T.P., R. 193 at 532; 533).

The principal operating officers of these companies were Robert R. Hills and the third party defendant Rufus B. Hurst. Hills was the president of H.M.W., Bethel Resources and Bethel Securities as well as being an officer and director of Fenex. Mr. Hurst was the person principally responsible for the day to day management and administration of the companies. (Stipulation, R. 123 at 12; T.P., R. 193 at 520-21)

From 1976 until August of 1981, Frost represented Fenex, H.M.W., Bethel Resources and Bethel Securities substantially with reference to securities matters. He never served as an officer or director, nor was he ever a shareholder in any of the companies (T.P., R. 197 at 1076).

Until late August of 1980, Frost's representation of these companies was routine and uneventful. He handled the mundane legal problems common to the oil and gas business. Many of these centered around the oil and gas leases, and included title problems, delay rental problems and lapse problems (T.P., R. 197 at 1097-1105). Frost handled some minor tax problems involving personal property, franchise and federal information tax returns which the companies' outside accountant had neglected to complete (T.P., R. 197 at 106-08; T.P., R. 192 at 410-11). He also was involved in routine audits conducted by the oil and gas section of the Ohio Division of Securities. Both Frost and the Commissioner of the Ohio Division of Securities described these audits as "routine", and both testified that the Division staff was satisfied with the results of the audits (T.P., R. 198 at 1288; 1323; 1328; R. 197 at 1126-29; 1131).

On August 28, 1980, Frost met with Rufus Hurst at the company offices in connection with a routine Division audit (T.P., R. 197 at 1133-41). Because Bethel Resources was doing the drilling for Fenex, there were no internal invoices from third party contractors to show the Division that a well had been drilled as had been the case in earlier audits. Frost suggested to Hurst that they could show the Division how much they spent for drilling by comparing the budget estimate with the balance of the money in each account (T.P., R. 197 at 1136-37). Hurst informed Frost that separate Fenex accounts had not been maintained, but that all Fenex monies were being kept in a single cash management account (T.P., R. 193 at 692-93; 697-98; 706-07).

Frost was not told that the companies could not account for the investors' monies and he was specifically told that there was no problem with H.M.W. and that separate accounts were being maintained for H.M.W. offerings (T.P., R. 194 at 693; 697-98; 700; 704; T.P., R. 197 at 1140-42; 1152-53).

In the beginning of October, Frost learned for the first time that Fenex did not have enough money to complete the wells.

This was due to cost overruns. Bethel Resources had been paid to drill the wells, but due to failures in drilling and other cost overruns, it had used up the money paid by Fenex for the drilling (T.P., R. 197 at 1151-52). At that time, Frost was not aware of how much money was involved.

From August 28, 1980 through November 26, 1980, Frost prepared no further Fenex offerings. A November 26, 1980 offering was submitted only after a conference with the Division of Securities on November 13, 1980, at which time the failure to segregate monies and the shortage of cash was again disclosed to the Division (T.P., R. 194 at 711-12; T.P., R. 197 at 1156-61).

The following is a chronology of events and actions taken by Frost, subsequent to his initial discovery that monies had not been segregated:

1. At the August 28, 1980 meeting, Frost instructed Mr. Hurst to immediately place the proceeds of the Campbell-Uhler offering currently being sold into a separate account. Frost periodically and randomly checked the passbooks to insure that his instructions were being carried out. (T.P., R. 194 at 704-05; T.P., R. 197 at 1142-43; 1159).

2. Frost demanded and several days later received a meeting with Robert R. Hills, Chairman of the Board and a principal shareholder of Fenex. At that meeting Hills expressed his belief that it was not much of a problem that the money was not kept in separate accounts because all the money was in a cash management account. Frost explained, "when you make a representation in an offering circular that you are going to keep it in a separate account, you are going to keep it in a separate account." (T.P., R. 197 at 1141-42)

3. In early October of 1980, Frost learned for the first time that the companies were short money, although the amount was unknown. At that time it was believed to be a Bethel Resources, and not a Fenex, problem since

Fenex had substantial assets of approximately $1.5 million (T.P., R. 197 at 152; 1164-65).

4. After Frost learned that there was a shortage of cash he did not prepare any additional Fenex offering circulars (T.P., R. 197 at 1153).

5. Frost forthwith reported the fact of financial difficulty to the Ohio Division of Securities (T.P., R. 194 at 711-12; T.P., R. 197 at 1158; 1162).

6. Thereafter, in response to Frost's disclosure to the Division of Securities, it issued a subpoena on October 10, 1980 which the company complied with on October 23, 1980 (T.P., R. 198 at 1295).

7. Frost resumed preparation of Fenex offering circulars only after a conference with the Division of Securities on November 13, 1980 (T.P., R. 197 at 1153; 1156; 1158).

8. Frost was informed by his client that they had received an oral loan commitment from the Pittsburgh National Bank for at least $500,000. The written commitment which was received on or about November 17, 1980 was forwarded to the Division of Securities by Frost on November 20, 1980 (T.P., R. 197 at 1162).

9. After these events the Division of Securities gave the go ahead for further offerings (T.P., R. 197 at 1159-60; 1167-68).

10. Frost continued to periodically and randomly check to see that the monies were segregated in separate passbook accounts. This included personal visits to the company offices to verify segregation as well as having Mr. McQueen come to his office to show Frost passbooks. Additionally, Frost required that Mr. McQueen's signature be added to Mr. Hill's signature for transactions involving these separate accounts (T.P., R. 194 at 704; T.P., R. 197 at 1159).

11. A copy of the separate passbook account for the Campbell-Uhler package was forwarded to the Division by Frost's November 26, 1980 letter, the same letter which enclosed the documentation for the Fenex, Campbell-Gallapoo-Weekley offering, the first offering after Frost learned of and disclosed to the Division the shortage of monies (PX 150).

12. On December 3, 1980 Frost again wrote Mr. Warneka of the Division of Securities with reference to the Campbell-Gallapoo-Weekley package and the maintenance of monies in separate accounts. The Division was invited to examine the offering and confirm these facts for itself (PX 151). On December 16, 1980 Frost wrote Mr. Warneka of the Division of Securities with reference to the Miller, Sherrick and Schultz package and once again reiterated that the companies understood the Division required monies to be maintained in separate accounts (DX 411). This offering was approved by the Division on December 30, 1980 (PX 1090).

13. On January 7, 1981 Frost sent the Division of Securities additional well completion records (Marting, T.P., R. 198 at 1321).

14. On January 22, 1981 Frost received from Rufus Hurst the final calculations as to the amount of money needed by Bethel Resources to complete its obligations to Fenex and these were delivered to the Division of Securities (T.P., R. 197 at 1151; 1186; DX 426 and 427).

15. On February 4, 1981 Frost met with Mr. LeGrand of the Division of Securities and delivered additional well completion records and reported on the segregation of funds (T.P., R. 197 at 1186; PX 155).

16. On February 6, 1981 Frost wrote Mr. LeGrand following up their meeting of February 4, 1981 and produced additional records (PX 255).

17. According to Roger Marting, the Commissioner of

the Division of Securities, the Division was satisfied at that point and no further action was taken in connection with the audit (Marting, T.P., R. 198 at 1322-23).

In July of 1981, a number of events occurred which eventually led to the financial demise of Bethel Resources, and thereafter Fenex and H.M.W. In July of 1981, the Pittsburgh National Bank withdrew its written commitment to extend Bethel Resources a $500,000 to $1,000,000 line of credit. Simultaneously, Rimco cancelled its substantial drilling contracts with Bethel Resources. These two events caused approximately eighty percent (80%) of Bethel Resources' cash flow to evaporate. Unbeknownst to Frost and acting without his counsel, Hills and Hurst then pledged the assets of Bethel Resources, Fenex and H.M.W. to certain creditors of Bethel Resources in order to satisfy debts owed to them and to secure further credit. Because of the Rimco and Pittsburgh National Bank developments, Bethel Resources had no cash flow to complete turnkey drilling obligations which it owed to Fenex and H.M.W.

On learning of these events and of the fact that Fenex was failing to segregate monies raised on the only package then being offered, Frost ordered Hills and Hurst to return the money to the investors — which they did — and he resigned as counsel (R. 194 at 619-25; 630-38; 642-45; R. 195 at 838; 868-71; 887-89; R. 197 at 1186-91; 1196; 1198A-99).

REASONS FOR DENYING THE WRIT

I. As conceded in petitioners' brief, the Sixth Circuit applied the proper standard for review in determining whether there was sufficient evidence to create a jury issue.

Petitioners, in framing their first question presented state that the Sixth Circuit's standard for review of the trial court's ruling on a motion for directed verdict is in conflict with the decisions of this Court and other circuits.

However, on page 11 of their brief, petitioners concede that: "The Sixth Circuit's error was not in stating the standard for review, but in applying it." (Brief of Petitioners, at 11)

Petitioners' misleading statement of the question presented is nothing other than a patent plea to this Court to engage in a second extensive review of the record, presumably to their benefit.

After their misleading description of the question presented, petitioners embark upon a confusing and esoteric discussion of the application of the standard of review in F.E.L.A. cases. Petitioners conclude their dissertation with a sweeping statement that: ". . . the federal standard for appellate review of a denial of a directed verdict motion is in a state of conflict and confusion." (Brief of Petitioners, at 16) Respondents would submit that only the petitioners are confused.

First, the standard of review applied by the Sixth Circuit in this case is identical in substance, if not in exact language, to the standard of review applied by this Court in F.E.L.A. actions. In this case, the Sixth Circuit in its opinion set forth the standard of review as follows:

> In considering a motion for a directed verdict under rule 50(a), the trial court "must determine whether there was sufficient evidence presented to raise a material issue

> of fact for the jury." *O'Neill* v. *Kiledjian*, 511 F.2d 511, 513 (6th Cir. 1975). As applied in this context, "sufficient evidence" is such that, when viewed in the light of those inferences most favorable to the nonmovant, . . . there is either a complete absence of proof on the issues or no controverted issues of fact upon which reasonable [minds] could differ.

809 F.2d at 303.

Hence, the Sixth Circuit described two yardsticks by which a court must measure whether there is a lack of evidence sufficient to raise a material issue of fact for the jury: (1) a complete absence of proof; or (2) an absence of controverted issues of fact upon which reasonable minds could differ. Compare this language with this Court's description of the standard of review in *Lavender* v. *Kurn* (1946) 327 U.S. 645:

> . . . Whenever facts are in dispute or the evidence is such that fair-minded men may draw different inferences, a measure of speculation and conjecture is required on the part of those whose duty it is to settle the dispute by choosing what seems to them to be the most reasonable inference. Only when there is a complete absence of probative facts to support the conclusion reached does a reversible error appear.

327 U.S. at 653.

Respondents also would point out to the Court that the standard for reveiw for directed verdict must be viewed in the context of the particular type of action. Certainly it is no coincidence that petitioners chose to rely upon F.E.L.A. cases wherein this standard was applied. The degree of proof required in an F.E.L.A. case as contrasted with that required in a case involving common law fraud and aiding and abetting a violation of Rule 10b-5 are quite different.[1]

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[1] Further, respondents question what prejudice petitioners suffered in this case. Petitioners had the benefit of a standard for review most favorable to their position.

As this Court noted in *Rogers* v. *Mo. Pacific R.R. Co.*, (1957) 352 U.S. 500, 506:

> Under this statute [F.E.L.A.] the test of a jury case is simply whether the proofs justify with reason the conclusion that employer negligence played any part, *even the slightest*, in producing the injury or death for which damages are sought. (emphasis supplied)

The quantum of proof in a 10b-5 case differs dramatically. To establish proof against a party as an aider and abettor, plaintiff must establish three elements:

1. A primary party has committed a securities law violation;
2. The aider and abettor had a general awareness that his role was part of an overall activity that was improper; and
3. The alleged aider and abettor knowingly and substantially assisted the violation.

S.E.C. v. *Washington County*, (6th Cir. 1982) 676 F.2d 218, 224.

Most of the circuits have held that the *scienter* element of an aiding and abetting violation can be satisfied by a showing of "recklessness". The Sixth Circuit has defined recklessness as: ". . . highly unreasonable conduct which is an extreme departure from the standards of ordinary care." *Mansbach* v. *Prescott, Ball & Turbin*, (6th Cir. 1979) 598 F.2d 1017, 1025. *See, e.g., Armstrong* v. *McAlpin*, (2d Cir. 1983) 699 F.2d 79, 91; *Woodward* v. *Metro Bank of Dallas*, (5th Cir. 1975) 522 F.2d 84.

Further, in cases involving nondisclosure, inaction and/or silence, the Sixth Circuit has held that there must be proof that the conduct of the accused aider and abettor ". . . was *consciously* intended to aid the securities law violation." *Washington County, supra*, 676 F.2d at 226.

Similarly, in an action for common law fraud under Ohio law, the representation must be false and material and it must be made with knowledge of its falsity and with intent to mislead the other party into relying upon it. *Dunn Appraisal Co.* v. *Honeywell Information Systems, Inc.*, (6th Cir. 1982) 687 F.2d 877.

As pointed out by petitioners in their brief, the Sixth Circuit applied the correct standard for review. Respondents submit that the court applied the standard properly, particularly when viewed in the context of the type of claims involved in the within action.

II. An attorney for an issuer of securities does not have a duty to *correct* a material misstatement of fact contained in an offering circular he prepared, where, immediately after he learns that a statement or statements contained in the circular are false, he insists that his client conform its conduct to the representations in the offering circular.

Contrary to the facts stated on page 17 of petitioners' Petition for a Writ of *Certiorari*, on August 28, 1980, Mr. Frost learned that the company had failed to maintain separate accounts with reference to *Fenex* offerings only. He was specifically informed that there was no problem with H.M.W. and that separate accounts were being maintained for H.M.W. offerings. (T.P., R. 194 at 693; 697-98; 700; 704; T.P., R. 197 at 1140-42; 1152-53) On August 28, 1980, when Mr. Frost learned of this failure to maintain separate Fenex accounts, one Fenex package was being offered for sale to investors. Frost instructed Mr. Hurst to immediately place the proceeds of that offering package (Campbell-Uhler) into a separate account. Frost periodically and randomly checked the passbooks to insure that his instructions were being carried out. (T.P., R. 194 at 704-05; T.P., R. 197 at 1140-42; 1159)

Under these circumstances, the trial court held that Frost was under no duty to correct the offering circular most recently issued (Campbell-Uhler). (C.A. Opinion, at 17)

On appeal, petitioners' second issue presented for review was:

> Is an attorney liable for participating in or aiding and abetting securities laws violations after the attorney has actual knowledge that registration statements and prospectuses, which he prepared for ongoing offerings, contain omissions and misstatements of material facts, but the attorney does not advise the issuer to offer rescission, sticker offering circulars, or suspend the offerings?

Brief of Appellants, Franklin and Julia Moore in the Sixth Circuit Court of Appeals, at 25.

In support of its position on this issue, petitioners cited and discussed the same cases they cite herein, *S.E.C.* v. *Nat'l Student Marketing Corp.*, (1978) 457 F. Supp. 682 and *Rose* v. *Arkansas Valley Envt'l & Util. Auth.*, (1983) 562 F. Supp. 1180.

In *NSMC*, counsel for two public corporations which were planning to merge discovered that the net income of the acquiring corporation had been materially overstated in the financial statements distributed to the shareholders prior to their voting on the approval of the merger. This discrepancy in the financial statements was discovered prior to the closing of the merger by counsel for both corporations. The closing went forward and the financial overstatement was not disclosed to the former shareholders of the acquired corporation, the S.E.C. or the general public. Additionally, neither attorney withdrew their legal opinions prior to the merger closing. The S.E.C. brought an action for injunctive sanctions against the former president of the merged corporation and counsel for the merged corporation. The Commission's allegations of aiding and abetting against counsel for the merged corporation fell into four categories:

(1) The failure of the attorney defendants to take any action to interfere in the consummation of the merger;

(2) The issuance by the attorneys of an opinion with respect to the merger;

(3) The attorneys' subsequent failure to withdraw that opinion and inform the Interstate shareholders or the S.E.C. of the inaccuracy of the nine month financials; and

(4) The issuance by the attorneys and (the president of the merged corporation) of an opinion and letter, respectively, concerning the validity of the stock sales under Rule 133.

457 F. Supp. at 712.

The court, in discussing these allegations, stated:

> The major problem arising with regard to the Commission's contention that the attorneys failed to interfere in the closing of the merger is whether inaction or silence constitutes substantial assistance. While there is no definitive answer to this question, courts have been willing to consider inaction as a form of substantial assistance when the accused aider and abettor had a duty to disclose.
>
> * * *
>
> Upon receipt of the unsigned comfort letter, it became clear that the merger had been approved by the Interstate shareholders on the basis of materially misleading information. In view of the obvious materiality of the information, especially to attorneys learned in securities law, the attorneys' responsibilities to their corporate client required them to take steps to insure that the information would be disclosed to the shareholders. However, it is unnecessary to determine the precise extent of their obligations here, since it is undisputed that they took no steps whatsoever to delay the closing pending disclosure to and resolicitation of the In-

> terstate shareholders. But, at the very least, they were required to speak out at the closing concerning the obvious materiality of the information and the concomitant requirement that the merger not be closed until the adjustments were disclosed and approval of the merger was again obtained from the Interstate shareholders. Their silence was not only a breach of this duty to speak, but in addition lent the appearance of legitimacy to the closing. The combination of these factors clearly provided substantial assistance to the closing of the merger.

Id. at 713, 714.

Rose v. *Arkansas Valley Envt'l & Util. Auth.* centers around the issuance of certain revenue bonds. (1983) 562 F. Supp. 1180. Attorney Rausch acted as bond counsel and issued a bond opinion which was necessary in issuing and marketing the bonds. The matter was before the District Court on the motions to dismiss of Rausch and a co-defendant. Rausch attacked the sufficiency of the complaint as the allegations against him dealt solely with "omissions" and there was no allegation of the existence of any "duty" on his part to disclose such omitted matters. Rausch contended that he had no duty to disclose the omitted matters since he had no preexisting relationship of trust and confidence with the petitioners.

In its discussion of Rausch's duty, the court stated:

> As concerns traditional liability under 10b-5, there are in reality several ways in which a "duty" owed directly by a defendant to a plaintiff may come into being. The first, and most basic, of those situations exists whenever a defendant undertakes the affirmative act of communicating or disseminating information (which in this context refers to any form of communication or dissemination), with an intent, knowledge or awareness that the information will be communicated or disseminated to persons such as the plaintiff and will or may be utilized by them in connection with a purchase

or sale of a security. There is in such instances obviously a general obligation, or "duty", to speak truthfully; or, alternatively stated, a "duty" not to communicate something which is known to be untrue (or, perhaps, in which the defendant has so little basis for honest belief that the requisite degree of "recklessness" is involved). And encompassed within that general obligation is also an obligation or "duty" to communicate any additional or qualifying information, then known, the absence of which would render misleading that which was communicated. While this latter "duty" might loosely be described as a "duty to disclose," I would prefer, for purposes of distinguishing it from a true "duty to disclose," situation, dealt with below, to label it as a "duty not to omit." In reality, it is simply one facet of the general obligation to speak truthfully, arising out of and because of an affirmative act by the defendant in communicating. There is, of course, nothing new or startling in this concept; it is expressed in the literal terms of Rule 10b-5(b) itself, and has long been an integral part of the law of common law fraud and deceit.

At the opposite end of the spectrum, as I would rationalize the cases, is a different sort of "duty," which arises in true "non-disclosure" situations. In these instances there has been no affirmative act of communication by the defendant to the plaintiff which triggers an obligation on the defendant's part. The defendant's "duty" here, instead, is a matter which arises solely by virtue of some pre-existing special relationship with the plaintiff; and is what in some respects might be more accurately referred to as a "duty to come forward." It was this sort of "duty" with which the Supreme Court was concerning in *Chiarella*. As the Court held there, it exists only when there is "a relationship of trust and confidence between the parties." An example may be seen in *Bartels* v. *Algonquin Properties, Ltd.*, 471 F. Supp. 1132, 1147 (D.Vt. 1979) (general partners' relationship to limited partners).

> Midway between these two extremes may be seen yet a third situation in which a "duty" on the part of the defendant can arise. Involved here are instances where the defendant, in good faith, has communicated or disseminated information which later becomes known to him to have been false or misleading when made. In these situations, where the newly discovered information has a direct bearing upon the information previously given, the defendant has a "duty" to communicate the new information. As may be seen, this particular variety of "duty" combines certain features of both those outlined above. Analytically, it may be said to arise not because of any independent, personalized relationship of trust and confidence between the defendant and the plaintiff, but rather because of the defendant's prior affirmative act of communication. On the other hand, performance of the duty requires a further affirmative act of the defendant, in correcting the information previously conveyed, and the duty itself actually arises, and can be breached, only at such later time following the original communication as the defendant learns of the newly discovered information. For convenience sake, I would denominate this sort of "duty" as a "duty to correct."

Id. at 1206-08 (citations omitted).

The court went on to hold that since the allegations against Rausch did not arise out of a true nondisclosure situation, a preexisting relationship of "trust and confidence" was not required. Rather, Rausch had a duty to communicate the new information which affected his prior communications.

The instant case differs from both *NSMC* and *Rose*. Unlike the attorneys in *NSMC*, Mr. Frost had no fiduciary duty to petitioners.

In *Rose*, the attorney had issued an opinion which he failed to correct. In the instant case, Frost issued no opinion. Frost prepared an offering circular for his client which was true

and complete to the best of his knowledge at the time it was drafted. When he later learned that certain representations contained in the offering circular were not accurate, he took steps to put the issuer in compliance with the offering circular by instructing the issuer to place the money in a separate account. He further monitored the issuer's compliance with his instructions and reported the matter to the regulatory authority, the Ohio Division of Securities, and suspended further offerings. The Sixth Circuit, in addressing this issue, stated:

> In the instant case, we see no need to establish a hard and fast rule that an attorney has a duty to correct an offering circular when the attorney learns of a misrepresentation contained in the circular. Here, it is undisputed that Frost insisted that the funds collected at the time be maintained in separate accounts. Moreover, he periodically checked to make sure that the funds were being properly held. It is also uncontroverted that the funds collected from this offering and subsequent offerings were maintained as represented until the late spring or summer of 1981. In other words, rather than advising his clients to correct the offering circular, Frost insisted that his clients comply with the representations made in the offering circulars. Accordingly, we decline to hold Frost liable under these circumstances.

As petitioners properly state, the purpose behind the federal securities laws is to "provide investors with full disclosure of material information" and to "protect investors against manipulation of stock prices." *Ernst & Ernst* v. *Hochfelder*, (1976) 425 U.S. 185, 195. Petitioners, in their Petition, state "[T]he Sixth Circuit substituted a new duty 'to insist on compliance' for the traditional disclosure requirements of the federal securities laws." Petitioners' argument is nothing more than semantics. The court in *Rose* enunciated a "duty to correct" prior communications where they are later found to be inaccurate. Logically, a representation made may be cor-

rected in one of two ways. The communication itself may be modified to reflect the true state of affairs or, the true state of affairs may be modified to accurately comply with the representations previously made. In the instant case, Frost "corrected" the discrepancy between the facts and the representations, by forcing his client to modify its actions to comply with the representations made in the offering circular. The Sixth Circuit has not "substituted" a new duty. Rather, the Sixth Circuit has recognized that a duty to correct may be fulfilled in two ways.

Petitioners state that:

> [T]he securities attorney is faced with two irreconcilable interests: (1) the desire to avoid S.E.C. prosecution and private actions under the federal securities laws for failing to protect society's interest in assuring that innocent third parties are not victimized, and (2) the desire to act in accordance with legal professional standards that demand the protection of a client's confidences.

Petitioners' Petition, at 26.

In the instant case, Mr. Frost was never investigated or prosecuted by the S.E.C. and has acted in accordance with the legal professional standards governing his conduct while serving his clients.

In support of its contention that the S.E.C. has promulgated a separate standard of conduct for securities attorneys, petitioners cite a 1974 law review article, (Garrett, *New Directions in Professional Responsibility*, (March 1974) 29 Bus. Law 7), and the 1978 case of *National Student Marketing Corp.* However, the Commission's opinion in the case of *In re: Carter* belies petitioners' contentions. In *In re: Carter*, (1979) Fed. Sec. L. Rep. (CCH) ¶ 82,175, the S.E.C. invoked Rule 2(e) to determine whether attorneys Carter and Johnson should be suspended from practicing before the Commission. The Office of General Counsel's (OGC) allegations against the attorneys revolved around the representation of National Telephone Company. The OGC charged that the

attorneys did not reveal pertinent financial data which indicated a deteriorating financial condition. The OGC charged the attorneys with having willfully violated, and with aiding and abetting violations of §§ 10(b) and 13(a) of the Securities Exchange Act of 1934, and Rules 10b-5, 12b-20 and 13a-11. *Id.* at ¶ 82,180. The OGC also charges that the attorneys did not possess the requisite qualifications to practice before the Commission in the representation of clients and that they had engaged in unethical and improper professional conduct.

The Administrative Law Judge found that the attorneys had notice of their clients' noncompliance with the securities laws and indifference to the attorneys' advice concerning disclosure, and found that as a result of this notice they had a duty to take action, but instead continued to assist their clients in committing the violations. The Administrative Law Judge found that the attorneys had violated §§ 10(b) and 13(a) of the 1934 Act as well as Rules 10b-5, 12b-20 and 13a-11 and had, therefore, performed in an unprofessional and unethical manner. Pursuant to Rule 2(e), the attorneys were suspended from appearing or practicing before the Commission.

The attorneys appealed the ruling of the Administrative Law Judge and the Commission dismissed the findings of securities laws violations and dismissed the findings of unethical or improper professional conduct. *In re: Carter*, (1981) Fed. Sec. L. Rep. (CCH) ¶ 82,847.

In discussing the Administrative Law Judge's finding that the attorneys had failed to carry out their professional responsibilities with respect to appropriate disclosure of material facts, the Commission stated:

> Respondents argue that the Commission has never promulgated standards of professional conduct for lawyers and that the Commission's application in hindsight of new standards would be fundamentally unfair. Moreover, even if it is permissible for the Commission to apply—without specific adoption or notice—generally

recognized professional standards, they argue that no such standards applicable to respondents' conduct existed in 1974-75, nor do they exist today.

We agree that, in general, elemental notions of fairness dictate that the Commission should not establish new rules of conduct and impose them retroactively upon professionals who acted at the time without reason to believe that their conduct was unethical or improper. At the same time, however, we perceive no unfairness whatsoever in holding those professionals who practice before us to generally recognized norms of professional conduct, whether or not such norms had previously been explicitly adopted or endorsed by the Commission. To do so upsets no justifiable expectations, since the professional is already subject to those norms.

The ethical and professional responsibilities of lawyers who become aware that their client is engaging in violations of the securities laws have not been so firmly and unambiguously established that we believe all practicing lawyers can be held to an awareness of generally recognized norms. *We also recognize that the Commission has never articulated or endorsed any such standards.* That being the case, we reverse the Administrative Law Judge's findings under subparagraph (ii) of Rule 2(e)(1) with respect to both respondents. Nevertheless, we believe that respondents' conduct raises serious questions about the obligations of securities lawyers, and the Commission is hereby giving notice of its interpretation of "unethical or improper professional conduct" as that term is used in Rule 2(e)(1)(ii).

Id. at ¶84,169-70.

. . .

While precise standards have not yet emerged, it is fair to say that there exists considerable acceptance of the proposition that a lawyer must, in order to discharge

his professional responsibilities, make all efforts within reason to persuade his client to avoid or terminate proposed illegal action.

Id. at ¶ 84,170.

. . .

The securities lawyer who is an active participant in a company's ongoing disclosure program will ordinarily draft and revise disclosure documents, comment on them and file them with the Commission. He is often involved on an intimate, day-to-day basis in the judgments that determine what will be disclosed and what will be withheld from the public markets. When a lawyer serving in such a capacity concludes that his client's disclosures are not adequate to comply with the law, and so advises his client, he is "aware", in a literal sense, of a continuing violation of the securities laws. On the other hand, the lawyer is only an adviser, and the final judgment—and, indeed, responsibility—as to what course of conduct is to be taken must lie with the client. Moreover, disclosure issues often present difficult choices between multiple shades of gray, and while a lawyer's judgment may be to draw the disclosure obligation more broadly than his client, both parties recognize the degree of uncertainty involved.

Id. at ¶ 84,171.

. . .

C. "*Unethical or improper Professional Conduct.*" The Commission is of the view that a lawyer engages in "unethical or improper professional conduct" under the following circumstances: When a lawyer with significant responsibilities in the effectuation of a company's compliance with the disclosure requirements of the federal securities laws becomes aware that his client is engaged in a substantial and continuing failure to satisfy

those disclosure requirements, his continued participation violates professional standards *unless he takes prompt steps to end the clent's* [sic] *noncompliance*. The Commission has determined that this interpretation will be applicable only to conduct occurring after the date of this opinion.

We do not imply that a lawyer is obliged, at the risk of being held to have violated Rule 2(e), to seek to correct every isolated disclosure action or inaction which he believes to be a variance with applicable disclosure standards, although there may be isolated disclosure failures that are so serious that their correction becomes a matter of primary professional concern. It is also clear, however, that a lawyer is not privileged to unthinkingly permit himself to be co-opted into an ongoing fraud and cast as a dupe or a shield for a wrongdoing client.

Initially, counselling accurate disclosure is sufficient, even if his advice is not accepted. But there comes a point at which a reasonable lawyer must conclude that his advice is not being followed, or even sought in good faith, and that his client is involved in a continuing course of violating the securities laws. At this critical juncture, the lawyer must take further, more affirmative steps in order to avoid the inference that he has been co-opted, willingly or unwillingly, into the scheme of non-disclosure.

The lawyer is in the best position to choose his next step. Resignation is one option, although we recognize that other considerations, including the protection of the client against forseeable [sic] prejudice, must be taken into account in the case of withdrawal. A direct approach to the board of directors or one or more individual directors or officers may be appropriate; or he may choose to try to enlist the aid of other members of the firm's management. What is required, in short, is some prompt action that leads to the conclusion that the lawyer is engaged in efforts to correct the underlying

problem, rather than having capitulated to the desires of a strong-willed, but misguided client.

Id. at ¶ 84,172 (emphasis added).

. . .

D. *Conclusion*. As noted above, because the Commission has never adopted or endorsed standards of professional conduct which would have applied to respondents' activities during the period here in question, and since generally accepted norms of professional conduct which existed outside the scope of Rule 2(e) did not, during the relevant time period, unambiguously cover the situation in which respondents found themselves in 1974-75, no finding of unethical or unprofessional conduct would be appropriate. That being the case, we reverse the findings of the Administrative Law Judge under Rule 2(e)(1)(ii). In future proceedings of this nature, however, the Commission will apply the interpretation of subparagraph (ii) of Rule 2(e)(1) set forth in this opinion.

Id. at ¶ 84,173.

It is clear that Frost has fulfilled the requirements of the S.E.C. as stated in *In re: Carter* as he took "prompt steps to end the clients noncompliance". Frost was not confronted with the situation presented in *NSMC* and *Rose* involving a client about to commit a fraud, but rather, with the matter of a client keeping funds in the wrong type of bank account. Frost learned on August 28, 1980, when only one package was being offered for sale, that Fenex funds were being kept in a cash management account and not in separate accounts as had been represented. Thereafter, the funds were placed in a separate account and Frost's clients verified this to him, thus ending the noncompliance. Frost's efforts to insure compliance did not stop there. He periodically and randomly monitored his clients' compliance; he reported the facts to the regulatory authority and he suspended further offerings.

Petitioners' second question presented is:

> Does an attorney for an issuer of securities have a duty to correct material misstatements of fact in offering circulars he prepared for ongoing offerings, after he learns the statements he made are false and misleading.

Petitioners' Petition for a Writ of *Certiorari*, at 17.

The answer to that question is clearly yes. From a review of *Rose* v. *Arkansas Valley Envt'l & Util. Auth.* and the Sixth Circuit's opinion below, it is clear that an attorney does have a duty to correct information which he has communicated or disseminated which he later learns was false when made. It is also clear from the Sixth Circuit's decision below that his duty to correct may be fulfilled by either modifying the representations made or modifying the client's conduct to conform with the representations.

The discussion of the code of professional responsibility and the "position" which petitioners allege the S.E.C. has taken, is meaningless in the instant case. Mr. Frost was not prosecuted by the S.E.C. nor the Ohio State Bar Association for his actions. Further, neither the code of professional responsibility nor the S.E.C.'s standards for prosecuting Rule 2(e) violations establish the parameters of an attorney's civil liability as an aider and abettor of securities violations. Mr. Frost's defense at trial did not include a claim that he was unable to correct the offering circular or communicate with the regulatory authorities due to the code of professional responsibility. In fact, Mr. Frost disclosed all of the pertinent facts to the Ohio Division of Securities with the knowledge and consent of his clients. Under these circumstances, the alleged conflict between the code of professional responsibility and the S.E.C.'s "position" does not impact this case in any fashion and petitioners are apparently requesting this Court to issue an advisory opinion.

CONCLUSION

"The review of Writ of *Certiorari* is not a matter of right, but of judicial discretion, and will be granted only when there are special and important reasons therefor." Rule 17, Rules of the Supreme Court of the United States. Petitioners have failed to point out any special and important reasons which would compel this Court to review the instant case and from a review of the record and the decision below, it is clear that no such reasons exist. Accordingly, the Petition for Writ of *Certiorari* is not well taken and should be denied.

Respectfully submitted,

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No. 86-1745

In The

Supreme Court of the United States

OCTOBER TERM, 1986

FRANKLIN AND JULIA MOORE,
individually and as representatives of a class,
Petitioners,

v.

EARLE R. FROST, JR. AND BROWNFIELD, BOWEN, BALLY & STURTZ,
Respondents.

PETITIONERS' REPLY BRIEF

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I. BY MAKING FINDINGS OF FACT ON APPEAL TO SET ASIDE A JURY VERDICT WITH A REASONABLE EVIDENTIARY BASIS, THE SIXTH CIRCUIT CONTRADICTED THE HOLDINGS OF OTHER CIRCUITS AND THIS COURT.

In their Brief in Opposition, Respondents attempt to persuade this Court that "[a]s conceded in petitioners' brief, the Sixth Circuit applied the proper standard for review in determining whether there was sufficient evidence to create a jury issue." The Petition for Writ of Certiorari, however, makes it clear that while the Sixth Circuit may have quoted the correct standard of review, it certainly did not apply that standard. (*See*, Petition for Writ of Certiorari, at pp. 9-10).

Instead, the Sixth Circuit incorrectly determined that the standard of review permitted an appellate court to make its own findings of fact to set aside a jury verdict that had a reasonable evidentiary basis. Indeed, the Petition for Writ of Certiorari lists the numerous findings made by the Sixth Circuit in contradiction of the evidence presented at trial. (*See*, Petition for Writ of Certiorari, at pp. 7-9).

By making its own findings, the Sixth Circuit misapplied the standard of appellate review and contradicted the decisions of other circuits and this Court. Specifically, the Sixth Circuit failed to follow this Court's admonition in *Lavender vs. Kurn*, 327 U.S. 645, 653 (1946) that "where, as here, there is an evidentiary basis for the jury's verdict . . . the appellate court's function is exhausted, it being immaterial that the court might draw a contrary inference or feel that another conclusion is more reasonable." See also, Lavender vs. Kurn, 327 U.S. 645 (1946); *Tennant vs. Peoria & Perkin Union R.R. Co.*, 321 U.S. 29 (1944); *Rogers vs. Missouri Pacific R.R. Co.*, 352 U.S. 500 (1957); *Tiller vs. Atlantic Coast Line R.R. Co.*, 318 U.S. 54 (1943); *Atlantic & Golf Stevedores, Inc. vs. Ellerman Lines, Ltd.*, 369 U.S. 355 (1952); *Wratchford vs. S. J. Groves & Sons Co.*, 405 F.2d 1061 (4th Cir. 1969); *Continental Can Co. vs. Horton*, 250 F.2d 637 (8th Cir. 1957).

The true issue presented by this Petition is whether this Court's decisions in *Lavender* and other FELA cases should apply in non-FELA actions. As demonstrated by the split among the commentators and circuits, as well as within the Sixth Circuit itself, this is an issue in dire need of this Court's attention. *See*,

e.g., 9 C. WRIGHT & A. MILLER, *Federal Practice and Procedure* §2526 (1971) ("A decision by the Supreme Court, clearly stating which view it takes as to the scope of the FELA and Jones Act decisions would be of helpful guidance to the lower federal courts.")

II. THE LOWER COURTS AND THE SECURITIES BAR NEED THIS COURT'S GUIDANCE IN AN IMPORTANT QUESTION OF FIRST IMPRESSION UNDER THE FEDERAL SECURITIES LAWS: DOES AN ATTORNEY FOR AN ISSUER OF SECURITIES HAVE A DUTY TO CORRECT MATERIAL MISSTATEMENTS OF FACTS IN OFFERING CIRCULARS HE PREPARED FOR ONGOING OFFERINGS, AFTER HE LEARNS THE STATEMENTS HE MADE ARE FALSE AND MISLEADING?

Respondents do not dispute that this case raised, for the first time in a United States Court of Appeals, the important question of whether an attorney has the duty to correct or disclose known misstatements and omissions of material fact in offering circulars he has prepared. Likewise, Respondents agree that the purpose behind the federal securities laws is to protect investors against manipulation of stock prices and to provide investors with full disclosure of material information. *See, Ernst & Ernst vs. Hochfelder*, 425 U.S. 185 (1976).

Respondents argue, however, that the Sixth Circuit legitimately substituted a new duty "to insist on compliance" for the traditional disclosure requirements of the federal securities laws. In essence, the Respondents argue that the difference between a "duty to correct or disclose" and a "duty to insist on compliance" is nothing more than semantics because a representation may be "corrected" in one of two ways: 1.) an attorney may correct a representation by modifying it to reflect the true state of affairs, or 2.) an attorney may force his client to modify its actions to comply with the representations. Respondents never bother to explain how an attorney can "force" a client to modify its actions to comply with the representations made in an offering circular.

This point is particularly relevant to the case at bar because on January 22, 1981, Mr. Frost received a list which showed that Fenex and Bethel Resources had converted $709,000 from investors' accounts and needed an additional $830,000 just to complete and equip investors' wells. DX 426; T.P., R. 194 at 745-41. On that date, the $243,750 Fenex offering Mr. Frost

registered in November was still being sold to investors. In addition, three HMW offerings, with a combined price of $275,000, were being sold to investors. PX 109.

Respondents fail to recognize that this Court's guidance is needed to maintain the paramount goal of the federal securities laws -- to provide the investors with full disclosure of material information. This goal cannot be accomplished by supplanting the traditional "duty to disclose" with an unrealistic duty "to insist on compliance."

Similarly, Respondents fail to recognize the dilemma facing a securities attorney who must choose between 1.) his duty, imposed by the American Bar Association's Code of Professional Responsibilty or Model Rules of Professional Conduct, to zealously represent his client and protect his client's confidences and secrets, and 2.) his duty, advocated by the SEC and the federal securities laws, to give primary allegiance to the investing public.

Without offering any support for their proposition, Respondents claim that the SEC's opinion in *In re: Carter,* Fed. Sec. L. Rep. (CCH) ¶ 82,175 (1979) "belies Petitioners' contentions."

Numerous commentators, however, have fully explored the holding in *Carter* and concluded that the securities attorney faces the dilemma posed in the Petition for Writ of Certiorari. In a recent New England Law Review Article, for example, Richard Kahn carefully examined the holding in *Carter* and concluded as follows:

> With the case of *In re Carter,* and the standard enunciated therein, the Commission has assumed authority to discipline attorneys as never before .... By having its own set of attorney conduct standards, the Commission is undermining the function of the local bar associations, who are responsible for maintaining the integrity of the profession .... Leaving the determination of proper rules of conduct to the local bar associations will ... alleviate any possible confusion resulting from the differing standards being imposed by more than one authoritative body. A single standard will require only a single interpretation, thus eliminating confusion as to where primary responsibilities lie.

Kahn, *Attorney Discipline by the SEC: 2(e) or not 2(e), 17* New England Law Review 1267 (1982).

Likewise, Marc J. Goldstrom painstakingly analyzed the holding in *Carter* and made a comprehensive analysis of the dilemma facing a securities attorney:

> [T]he Securities and Exchange Commission (SEC) has advocated the position that securities lawyers must assist in maintaining the honesty and integrity of the securities market, including in certain circumstances, a duty to report a client's intended or past violations to the Commission. Yet, aspects of the SEC's position are inconsistent with the provisions of the American Bar Association's Model Code of Professional Responsibility. Thus, securities attorneys face the dilemma of deciding which set of guidelines to follow. Further, by choosing one set of guidelines, the attorney may subject himself to liability for violating the other set of guidelines. The solution to this dilemma is a single set of guidelines upon which the securities bar may rely.

Goldstrom, *Secondary Liability of Attorney's for Securities Law Violations--the Need for a Single Standard of Attorney Conduct,* 30 Wayne L. Rev. 65 (1983).

By granting this Petition for Writ of Certiorari, this Court has the opportunity to assist the lower courts and the securities bar in determining whether an attorney has a duty to disclose or correct known misstatements and omissions in offering circulars he has prepared.

CONCLUSION

In this case, the Sixth Circuit scoured the record in an effort to find circumstantial evidence that conflicted with the jury's verdict. Such a standard of appellate review is clearly contrary to this Court's decision in *Lavender* and numerous other FELA cases. But the United States Courts of Appeals, including the Sixth Circuit itself, are in a state of conflict and confusion, not knowing whether this Court intended for its FELA decisions to apply in a non-FELA action.

Similarly, the lower federal courts and the securities bar need this Court's guidance in order to establish a uniform rule regarding an attorney's duty under the federal securities laws to correct known misstatements and omissions of material fact in offering circulars he has prepared.

This petition for writ of certiorari should be granted so that this Court can give its badly needed guidance on these crucial issues.

Respectfully submitted,

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